TRANSACTIONS OF SOCIETY OF ACTUARIES
1959 VOL. 11 NO. 29AB

PANEL DISCUSSION

THE CHANGING PATTERN OF LIFE INSURANCE INVESTMENTS IN THE UNITED STATES

New York Regional Meeting panel members:

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CHARLES A. SPOERL, *Moderator*

MILFORD A. VIESER:

For more than one hundred years the changing pattern of life insurance investments has been the story of our expansion from a small agricultural country of about twenty million persons to a great nation in an advanced stage of industrialization.

In early years our investments were primarily local and they contributed to the development of nearby communities through real estate mortgages and policy loans.

In the latter part of the nineteenth century, the American economy became integrated through the development of a new and vast transportation system. As life insurance companies grew during this period, their funds flowed heavily into railroad bonds. The investment field of life companies at that time was a reasonably simple and familiar one. Few companies had investments beyond government bonds, railroad securities and mortgage loans. As the growth of railroads subsided, life companies' investments in their securities became less important and their holdings declined.

In the past fifty years, life insurance funds have made substantial contributions to the development of public utilities and other industrial companies. The great construction era which followed World War I was implemented by mortgage loans for private housing and building.

During business booms life insurance funds have aided in building America to a great industrial and agricultural strength. In deflationary cycles policy loans have been the source of assistance to individual borrowers. During all the wars, life funds virtually ceased flowing into conventional investment fields and supported instead the government credit needs. The record shows clearly that monies invested by life companies have tended to flow where they were most needed by the national economy.

The Growth of Life Insurance Assets

As the country grew in wealth and population, the life insurance companies became an industry of importance in our nation's economy and a major factor in its financial operations. They have become the most important channel where the savings of individuals are marshaled to meet the long-term capital requirements of the country.

Today 110 million persons own a total insurance in force of over $458 billion in 1,300 legal reserve companies whose total admitted assets are over $100 billion. Over 70% of our people own some kind of life insurance.

The great growth of our industry emphasizes the vital fact that a large proportion of the total capital of the country has been provided by the investments of life companies, that a great part of the total individual savings of the country is being entrusted to them. These facts show clearly that life insurance companies have a responsibility, not only to their policyholders, but to the public interest. The industry is so big, and it plays such a prominent role in our system of capital formation, that it cannot escape social responsibility.

The Fundamental Nature of Life Insurance Company Investments

What can the insurance industry invest in? What should it invest in? These are questions that have been deliberated for many years.

Historically, and by law, life companies have invested in debt instruments—bonds and real estate mortgages. It has been almost universal that they have limited their investments to obligations having a first claim on assets and a prior claim on earnings.

Probably the most fundamental reason for this policy is that life insurance assets have been traditionally regarded as trust funds, and their investment in the most secure investment medium has, therefore, seemed proper. On the more technical side, the investments represent policy reserves, annuity reserves, reserves under supplemental contracts. The mathematical calculation of the reserves assumes a certain minimum return. The method of computation is prescribed and there is little room for fluctuation, particularly when the unassigned surplus averages about 8% for the industry. It has seemed proper that these reserves be backed by assets which appear best able to secure this steady type of return.

Currently, about 94% of the admitted assets of life companies are represented by debt instruments.

Life Insurance Investment Changes since World War II

Seldom in history has there been such a rapid change in the portfolios of life insurance companies as has happened since World War II. Rarely

have we seen, with such clarity, the remarkable fluidity of investments contributing to the nation's need.

At the beginning of World War II, the industry's government bond holdings amounted to 20% of assets. At the end of the war, government bonds had increased from six billion dollars to nineteen billion, or 47%—almost one-half of our assets.

Since the end of the war we have reduced our government bonds from about one-half of our assets to about 6.1% of assets. The funds from the sale of our government bonds, plus the funds from our growth, have been invested in the private economy to meet the needs of our people.

Financing of Postwar Housing

One of the big switches since the end of World War II has been the substantial increase in city mortgage loans. The tremendous pent-up demand for housing at the war's end resulted in about 13,000,000 housing units being constructed from that time to date. Our industry increased its mortgage account from 13.8%, a record low in 1946, to 33.7% of assets today; from $6,000,000,000 to $30,600,000,000. Of equal significance is the increase in mortgage loans insured or guaranteed through FHA and VA. In 1945 24% of our loans were so insured. Today 44% are government guaranteed.

While government insured loans—FHA and VA—have made a substantial contribution to better housing in America, and have also proved a most excellent avenue of investment, these blessings are not without serious problems. In a period of about twenty years, the housing and mortgage industry has gone from a complete private enterprise to one of substantial socialization. The influence of government control over housing interest rates and, as a result, over the flow of mortgage lending has been gradual but sustained.

It is essential that we guard against this government competition. We must constantly improve our conventional loaning practices. We must strengthen our appraising and mortgage underwriting methods and urge our correspondents to build up a sound conventional mortgage business, at the same time urging the government to develop a free market in government insured mortgages.

In early years farm mortgage investments became an important part of our portfolios and until the early twenties about equaled the amount invested in city loans. The change from an agricultural to an industrial economy, together with the economically unsound competition in the form of low interest rates by the Federal Land Banks, has reduced this type of investment to where only 3% of our assets are in farm mortgages.

There seems to be little prospect of any great increase in this form of investment in the near future.

Investment Real Estate

Another important change in investment practice occurred about 1945 when life companies were granted permissive legislation to purchase real estate for investment. Today we have over $3 billion in real estate, consisting of about $600 million in home office properties and $2.4 billion in investment real estate. The latter is equity ownership of properties and generally consists of commercial and industrial properties, lofts, factories, warehouses, office buildings, department stores and shopping centers. A substantial part of this account has been acquired on a leaseback basis providing the lessee firms with working capital and furnishing life companies with long term rentals from companies of substantial financial strength at higher yields than comparable bond issues or quality mortgage loans. A substantial part of this real estate was acquired in the past ten years and it is a growing account. Legislation, however, generally limits this type of investment to 5% of assets. During the early years life companies approached this new medium with caution and conservatism, dealing largely with the highest quality companies in modern, well located real estate. Today there is some tendency to measure risk for a greater yield and a higher future profit and thus improve our fixed debt yields.

Bond Securities

An additional big change in our portfolio is the substantial increase in securities of business and industry, from 24% of assets to 44% in fifteen years. The last decade has witnessed the greatest peacetime expansion of our country's production and distribution facilities on record. Business and industry has poured billions and billions of dollars into new plants and equipment. For this demand our industry has supplied most of the long term credit needs.

This tremendous demand for funds gave impetus to the direct placement of securities, a system whereby an insurance company or group of insurance companies negotiates directly with the borrower to provide the necessary funds, as against the use of investment bankers or the traditional mechanism of the public offering. This is an extension of the long term function of the commercial banker.

There are many reasons for the great growth of this practice. Many of the proposed financings were technical and complex and therefore it was much simpler to explain the need, use and expected results of the funds to a small group of experienced and sophisticated investors than to the

general public. Then there was the reluctance of some companies to make public all the information required, in a public offering, by the S.E.C., and conversely, the reluctance of the S.E.C. to permit a company to make projections in a registered statement as a basis for selling securities. Then, too, many loans provided funds for construction purposes and agreements could be made to take down funds as required. This eliminated the many difficulties of a public offering.

The system of direct placement of securities has many major advantages. It has proven most satisfactory to our industry because of the ability to negotiate favorable covenants (particularly against refunding), derive attractive investments at advantageous interest rates and retain continued direct contact with the borrower.

Today life insurance funds are at work in every community and in every home. It is difficult to find an industry in which life insurance funds have not been invested. Scientific research, now liberally financed by both government and business and staffed by the best and most imaginative scientists in the world, has added an incredibly long list of new products. It is constantly finding new ways for cheaper production in our ever widening market. We are financing industries whose products only a short time ago were dreams—jet planes, missiles, plastics, synthetic materials, electronics—and we will shortly be financing products that are presently in the test tubes of scientific research.

Inflation and Income Tax

Two problems of current concern for the industry are the new income tax bill and the general inflation that is eroding the savings of our people.

While it is not expected that the proposed tax law will make radical changes in our investment policies, it will make us all more cost-conscious, much more tax-conscious, and will cause a re-examination of investment practices. Particularly will we look with new interest at tax exempt securities and preferred stocks.

Inflation

Inflation is certainly the topic of the day and of the utmost concern to our industry and to our people. The fear that we will continue to have creeping inflation and the feeling that inflation is inevitable have resulted in a tendency for investors to have a lesser interest in the bond market and thus greatly increase their interest in the stock market. The long years of unbalanced budgets and deficit financing have developed a growing apprehension, both here and abroad, over our ability to keep our fiscal house in order. This has complicated the management of the government bond market and the money market.

People are now inflation-conscious and are putting more of their savings into equities as a hedge against such inflation. The stock market, mutual funds and real estate ownership are all more actively competing against life insurance for the people's savings.

There is increasing thought on the part of our investment managers to place our funds in common and preferred stocks. While the practices of individual companies vary, stock holdings have never bulked large in life insurance assets. At the end of the war, both common and preferred stocks were less than one billion dollars, or about 2% of our assets. Today common and preferred stocks amount to about 3.0% of our assets (1.6% in preferred stocks and 1.4% in common stocks).

The amount that we may invest in common stock holdings is limited by New York law to 5% of our assets or one-half of our unassigned surplus. Of great importance is the fact that we must list such stocks each year-end at market values. This proves to be a great limitation, particularly with companies having a low surplus. Last year the Insurance Commissioners approved a new system for valuing preferred stocks. The rule provides that we write preferred stocks one-fifth up or down the market change each year so that the impact upon surplus by violent changes in the market will be less harsh. It is my own personal hope that a more stabilized and better system of evaluating common stocks will ultimately be forthcoming.

While the various companies are studying common stocks for greater yield and greater growth, and many companies are today purchasing under a dollar averaging system, there would seem to be no great and substantial increase in this type of security in the immediate future.

The curbing of inflation will be of help to everyone. The maintaining of sound fiscal policies is the responsibility of the government, business and our people. It is to the great credit of our industry that we have given heavy support to those advocating and working for a balanced Federal budget, and we have been most articulate in efforts to stabilize the value of the dollar.

Change in Investment Department Operations

There have also been important changes in the methods of operation and in the personality and philosophy of our investment departments.

In early years when cash accumulated, it was invested in securities of public issue. Today, because of our construction loans, long mortgage commitments, and direct placements, because of our heavy and long forward commitment position, it is necessary to keep a meticulous control of cash flow. The need for cash flow statistics becomes of tremendous importance, because our ability to sell large quantities of government bonds has vir-

tually ended, or at least has been substantially reduced. Also, with the increase in business, our financial managers are faced with an unknown immediate need for funds due to fluctuations in payments to policyholders.

Our industry today is always well loaned up. Excess cash is immediately put to work—in some cases in short, temporary investments, treasury bills or commercial paper, until the long term commitments are paid.

The awareness of cash flow has made increased earnings for our policyholders. The more careful and rapid investment of our cash flow is the result of cooperation on the part of all the operating departments of our companies to bring together quickly all changes and anticipated changes in cash needs.

Today the investment business is one of intense competition. All categories of investments, bonds, stocks, insured mortgages and conventional mortgages, are competing with each other for the savings of our people. With demand for capital often high as compared to savings, investments in a free economy must compete in a free market by rate and term and quality.

Lest you have a picture of a life insurance investment department as a staid, stodgy group of oldsters constantly practicing new and intriguing methods of saying "no," let me correct your thoughts. For our life insurance investment business is one of intense competition—great competition of company against company—for high quality investments at high yields. Now our men are traveling all over the country inspecting and appraising buildings, factories and plants, analyzing utilities, industries, toll roads, and attending financial briefing sessions. As an industry, we have a fine group of competent, loyal men who have made a tremendously successful investment record. They are men who are accustomed to frequent and rather drastic change—in yields, in market conditions, in the economy, in confronting and creating new products, in new industries.

There is only one change which the investment men of your industry will not accept. There will be no change in our fundamental investment policy which is (1) safety of principal and (2) to secure the highest investment yield consistent with safety. There is little interest in speculative profit. Our purpose is to make sure that our policy contracts are met promptly at maturity.

The American people have implicit confidence that at death their insurance will be paid to their survivors, without any possibility of default. Our people have come to believe that the payment of life insurance is as certain as the rise of the sun tomorrow. The building up in the public's mind of such faith in the safety of life insurance is a great tribute to our

companies. We can continue to progress as an industry and we can continue to secure a large share of the savings of our people only if we keep our companies financially strong and retain the confidence of our people.

R. MANNING BROWN, JR.:

It is always with a great deal of reluctance that I quote figures, particularly in the presence of any actuary. However, I hope you will bear with me if I do quote a few well rounded ones as a starting point and in order to emphasize the magnitude of the life industry's investment in mortgages.

As of December 31, 1945 life insurance companies' assets were about $45 billion. As of the end of last year they are estimated as approximately $107 billion, about 2½ times the 1945 figure. In 1945, 14.8% of their assets were invested in mortgages for a total of about $6.6 billion. In 1958 the mortgage investment amounted to $37 billion, or somewhere in the neighborhood of 34% or 35% of assets. This is an increase of over $30 billion in the postwar period, about 5 times the 1945 investment. This $37 billion is made up of slightly over $19 billion in conventional loans, about $7½ billion each in VA and FHA loans and just under $3 billion in farm loans.

The conditions prevalent at the end of the war are well known to all of you. During the war years there were very few housing starts. The low point of 141,000 was reached in 1944. As a result, there was a pent-up demand for housing and need for construction of various types of commercial properties. During the same period there had been a dearth of good investment opportunities and a concentration by life insurance companies on the purchase of government bonds. As Dr. Nadler so aptly said, "The purchase of governments at that time was the prudent thing to do, the patriotic thing to do and the only thing you could do." Something like 45% of life insurance assets were in governments and the Federal Reserve Board was following a policy of supporting the price of these bonds at or close to par. So conditions were ripe not only for the sale of but for the financing of a great volume of new construction, not only of homes but of office buildings, shopping centers, stores and other types. Our industry was equal to the challenge. From 1946 through 1951 life companies' holdings of mortgages increased over $12 billion. During the same period, government bonds were decreased by an amount only slightly less. By 1951, 28% of life companies' assets were invested in mortgages. The life insurance industry can be proud of its response to the acute housing shortage of the postwar period, as well as to the financing needs of this country's expanding business and industry.

In recent years, although a substantial number of dollars are going into the mortgage field, the rate of increase has slowed down somewhat. It is interesting to note that the percentage of our assets in mortgages has changed little in the past three years. Since the war over 14,000,000 new dwelling units have been started. This is an average of over 1 million each year. Some of the vitality in the market for new homes has been exhausted, although there continues to be a good demand. Arguments for and against any given number of housing starts are endless, but I believe there is no contradicting the fact that because of this terrific volume of construction these last 12 years, the underlying strength in the market is not what it used to be, and there have been instances where certain communities may have been overbuilt temporarily. Secondly, life insurance companies can no longer reduce their holdings of governments at the rate which prevailed in the early postwar years. By and large they are living entirely on their income, and investment funds cannot be supplemented by the proceeds of any substantial sale of assets. Third, generally speaking, there has been no shortage of investment opportunities. In fact, the investment officers have had more loans offered to them, both corporate and mortgages, than they have funds with which to make these loans. So, there has been a problem of selecting between desirable investment opportunities. There is little justification for making mortgages unless the return is as attractive as that available through other investment media. The more we can earn on our investments, the more insurance can be purchased for the same number of dollars. This is a competitive business.

Right at the moment, because of the yields that have been obtained in the private placement field, there has been no compelling reason from a return point of view to step up the rate of insured mortgage acquisitions. Let's take a look at this a little more closely. Today a return of $5\frac{1}{4}$ or $5\frac{1}{2}\%$ is not unusual in a direct placement. As the expense factor is not great there is little difference between the gross rate and the net before taxes. On the other hand, let us look at the return on a residential mortgage. The gross rate on a loan guaranteed by the Veterans Administration is fixed by law at $4\frac{3}{4}\%$. This type of investment a few years ago was an attractive one for the life insurance industry. It is virtually riskless and is a very satisfactory outlet when the rate is right. However, the gross rate of $4\frac{3}{4}\%$ is far from the net. In the first place, it is customary for life insurance companies to pay their servicers $\frac{1}{2}$ of 1% for servicing. In addition, various home office costs involved in handling these smaller loans are estimated at something like $\frac{1}{4}$ of 1%, so a gross rate of $4\frac{3}{4}\%$ becomes a net rate of about 4% and at this figure there is practically no life insurance money going into the VA field now. Discounts are permitted but

are generally avoided because of the public relations implications. FHA residential loans bear a maximum permitted rate of $5\frac{1}{4}\%$, although this can be administratively increased. It requires a slight discount to make the rate interesting. The result has been increasing emphasis on the part of mortgage officers to make conventional residential loans and commercial mortgages where the return can be adjusted to meet competitive conditions.

You may be interested in some recent figures prepared by the Life Insurance Association of America. Using the April 1951 figure as the base index of 100, outstanding mortgage commitments for 40 life insurance companies were 108 in January 1959. However, look at these index numbers:

Business and industrial mortgages	242
Farm mortgages	103
Nonfarm residential mortgages	64
FHA residential loans	57
VA loans	5
Conventional residential loans	176

These figures speak very eloquently of the swing from the FHA and VA field into the conventional category.

A rate that is administratively or legislatively determined cannot adjust rapidly to changes in the money market. As a result there is an anticyclical effect. When money rates are falling and funds are plentiful, as in 1953 or even last spring, the fixed rate on government insured housing looks good and money flows into this field. On the other hand, when money is somewhat less available and these rates fail to respond, money is diverted from the housing area into the commercial mortgage field and corporate field. In these fields there are more than adequate opportunities at competitive rates.

There is not time to report on pending housing legislation. Suffice it to say that housing seems to have a unique political appeal and each year sees the introduction of proposals a little more liberal than the last. Appropriations for direct loans to veterans at preferential rates and legislation requiring FNMA to buy FHA loans at the maximum terms at par are some of the problems with which we have been confronted recently. We are constantly faced with the threat of or existence of various Federal lending activities and with the threat of increased activities if private funds are not forthcoming. It has been our oft repeated position and we have not hesitated to appear before the House and Senate Banking and Currency Committees at any opportunity to say that private funds have demonstrated and will continue to demonstrate their willingness and

ability to finance the housing needs of this country provided it can be done at rates that are commensurate with returns in other avenues of investment.

Several years ago at the instigation of the life insurance industry the Voluntary Home Mortgage Credit Program was included in our housing legislation. This is a cooperative effort on the part of private lenders to make funds available for mortgages on homes in rural areas or to minority groups. It was an imaginative and bold attempt to demonstrate the job that private funds can do and to discourage the advocates of government encroachments in this direction. The results have been very impressive. Over $330 million in loans have been made under the program and by far the greatest share of these have been done by insurance companies. I think our industry can be very proud of what has been accomplished in this way.

What of the future? Despite temporary problems, mortgages will continue an important outlet for our funds. It would seem to me that perhaps the period of rapid growth of mortgage portfolios may be past for a little while. Acceleration may reappear with the predicted rise in family formation somewhere in the mid-60's. I would also expect to see a continuation of the movement toward the conventional field, both residentially and commercially. In the residential field we receive intense competition from the Savings & Loan Associations because of their higher permitted loan to value relationship and because as local institutions they may give speedier service to the potential borrowers. I think we will find that the commercial field offers us greater opportunities as new ideas, new methods, new needs emerge. I believe we will see increasing stress placed on the methods of mortgage acquisitions and servicing in order to reduce expenses.

The mortgage correspondent system for the most part is serving the industry well. Mortgage banking firms have become in many instances larger, more sophisticated and in much better financial condition than they were right after the war. As their portfolios grow and as they can make use of more efficient bookkeeping methods, we hope that some duplication of effort can be eliminated and cost savings realized so that the expense factor involved in mortgage yields can be reduced. Some few companies have decided that a branch office system of their own is better adapted for efficient production. This, of course, involves the building up of large overhead cost items which have definite drawbacks in periods of reduced lending activity.

The implications of the new tax bill cannot be overlooked. It is not impossible that the appeal of tax exemption may lessen the attractiveness of fully taxable income in the absence of substantial yield differentials.

All in all though, I think we will continue to see mortgages play an important role in our investment activity. The rate of acquisition will vary in response to prevalent conditions. There is no question but that we have developed an increased sensitivity to changes in the money market and this is as it should be. Funds will be drawn into those investment areas where the need is greatest, as will be reflected in the yield.

Our economy is subject to minor ups and downs, but on the whole it is an expanding one. I am sure our industry will continue to have the capacity, the initiative, the imagination, to play a vital part in this expansion.

CHARLES A. SPOERL:

I want to say a few words about what my distinguished colleague called the direct placement field. It has assumed an importance which I had not realized until I asked our people in the Aetna just how much was involved. They gave me figures for 20 years which indicate that over $100 billion of new money together with about $27 billion of refundings has been invested in securities, of which publicly sold bonds amounted to just under $60 billion, and bonds privately placed amounted to $44 billion; there were $27 billion of stock issues. This makes private placements a much larger piece of the picture than they were when I was handling investments some years ago.

We also broke down the present holdings of nonrailway corporate debt by insurance companies and others as follows:

	Private Placement			Public Issues		
	Utilities	Industrials	Total	Utilities	Industrials	Total
Insurance companies	$7 billion	$22 billion	$29 billion	$7 billion	$2 billion	$ 9 billion
Other holders	....	....	13 billion	....	....	49 billion

Three large companies have between 65 and 75 per cent of their assets invested in just two categories, private industrial placements and mortgages.

I might review the distinction between private placements and the ordinary bond issues that we used to buy. There are three ways that money can be borrowed nowadays. The borrower can sell bonds to an underwriting group, one or more investment bankers who then peddle them. If it is a railroad or public utility, or a municipality, it can sell its bonds by competitive bidding. Or it can do this direct placement operation.

Mr. Vieser has touched on some of the advantages of direct placements.

The fact is that some of these things are rather intricate, and the life insurance companies have people who can understand them and within a limited amount of time can perhaps get the investment picture a lot quicker than would be possible for the average investor if bonds were to be offered publicly. It is a lot easier to sell to people who understand the story rather than to try to explain some of these intricate things to every man who wants to buy a $1,000 piece.

As Mr. Vieser said, there is the question of giving away trade secrets if you have to register these things with the SEC, and that is something that a good many businesses do not want to do.

The question of the trustee comes up. Most of the conventional bond issues have corporate trustees who are supposed to take charge in case of unpleasantness like default and such things. Ordinarily these private deals are set up without a trustee, although they usually have provision for a trustee in case anybody wants to withdraw and sell his bonds to other investors.

Ordinarily there is a provision that if one of the holders wants to convert his x-million dollar piece into thousand dollar pieces, it may be done. In that case, there usually has to be a trustee, and very often there has to be registration with the SEC. I do not think this happens very much in practice, however.

The special situations in which a private deal is indicated are many. Some of them are quite interesting. A good many of them, as has been suggested today, involve long-term commitments. I think they are even thinking about a place for putting commitment fees in the annual statement at last. These fees are the consideration for giving a firm commitment to provide a borrower with funds on stipulated terms at a future date. There has been no natural place to list such receipts in the past because they have been earned on an investment that has not yet been made. There is quite a bit of money coming in along these lines nowadays.

Then, there are these 100 percent loans which, ordinarily, no person in his right mind would make on a property, but in the cases I am thinking of they are secured by some form of side agreement. Examples of the projects that have been financed in this way are ships under charter; gas stations under leases; oil pipe line financing in which you are guaranteed principal and interest regardless of the amount of oil going through the lines; chemical plants that make a single product whose sale has been guaranteed; office buildings and warehouses whose rent is the responsibility of a major corporation.

There are two rather interesting avenues of private placement now. One of them is in ship loans. I think it is Title XI, according to our young

man who is interested in these things, which provides that the Maritime Commission requires the Merchant Marine to renew its fleet each 20 years. In the past, financing has been provided by construction subsidy and direct loans from the United States Government. Now, however, much of this financing is being done by public or private deal, and the government's responsibility is reduced to construction subsidy and a guarantee of the ship mortgages.

If any of you ever did any financing involving a ship mortgage, you know it is very interesting. We did it some years ago. I went through the Legal Department and after they had told me, "No, we don't understand maritime law; no, we don't understand ship mortgages," we fell back on our fire and casualty affiliate, and one of the head underwriters in the marine department knew all about ship mortgages. Apparently the admiralty laws are all in different fields from the ordinary business law.

A good many companies have made some loans to airlines. There is no government guarantee of any of the trunk line loans. However, under the Civil Aeronautics Act, the government has to maintain the solvency, by subsidy or otherwise, of all certificated carriers. So there is an implied guarantee there.

There weren't any of these loans when I first went into the investment field in about 1927 or 1928, and I might conclude my remarks with the observation that making this kind of investment is a long way from buying general mortgage bonds of the Long Island Railroad.

Following the panel presentation, the members of the panel responded to questions concerning purchase of a part of a building horizontally, buying and lease-back of jet airplanes, and making loans on standing timber, and discussed the prospect that the demand for capital will continue to exceed private savings.

Omaha Regional Meeting panel members:

JOHN HAWKINSON, Vice President and Treasurer, Central Life
SANFORD M. THOMPSON
FERGUS J. MCDIARMID, *Moderator*

FERGUS J. MCDIARMID:

Life Insurance Investments

The pattern of life insurance investments during the last half century was pretty well established by the Armstrong Investigation of 1905 and the state laws resulting therefrom. The general inference of these laws was that debt-type investments, bonds and mortgages, were the proper investments for life insurance companies, while equity-type investments were largely to be avoided. The stock market crash of 1929 tended to confirm this type of thinking. In spite of the vast changes that have taken place in our economy since that time, and more particularly the emergence of inflation as our greatest economic problem, the investments of American life insurance companies today very largely reflect the philosophy which was established a half century ago under entirely different conditions. There have been some departures from this philosophy, it is true, but they have been rather minor and by no means universal. Life insurance companies on this continent have shown vastly less flexibility than their British counterparts in adjusting their investment policies to more recent economic conditions. This may be blamed on the fact that we must adhere to the established investment laws, but there is a degree of "buck passing" involved in this approach.

I should like to review very briefly the major shifts which have taken place in life company assets in the United States during the last ten years. At the end of 1948, the 49 large companies which have over 85% of the assets of the industry today had 97½% of invested assets in fixed dollar investments consisting of bonds, mortgages, and preferred stocks, and 2½% in equity-type investments consisting of common stock and real estate, the latter, of course, including home office buildings.

Ten years later these companies had 94.2% of invested assets in fixed dollar investments, while the percentage in common stocks and real estate had more than doubled to 5.8%. However, much of the increase in real estate was in commercial properties subject to long term, fixed dollar lease, and so should be classed, to a considerable extent at least, as fixed dollar investments. The proportion of common stock investments

increased in the ten years from ½% to 1.4% of assets, which reflects mainly the policy of a few large companies. This compares with at least 17% in common stocks on the part of the British companies and an additional 9% of their assets in real estate, or somewhat over one-quarter in equity-type investments.

The major and significant changes in the asset composition of American life insurance companies in the last ten years, therefore, took place mainly in the dominant fixed dollar category of bonds and mortgages, which still makes up over 93% of their total invested assets. These changes may be briefly summarized:

1. There has been a very heavy shift out of the U.S. government bonds. These have declined in absolute amount by about two-thirds or from 33% to less than 7% of invested assets. Apparently most life insurance companies now see little advantage in owning substantial amounts of U.S. government bonds. Because of their large cash flow resulting from both normal growth in assets and from the amortization of existing assets, they do not feel much need to purchase additional liquidity at the expense of yield. As a matter of fact, the additional liquidity actually provided by government bonds other than very short term issues is questionable. This was brought home to us last December when we tried to sell some of these bonds at their quoted prices for two days without success. Hardly anyone seems to want to own government bonds any more other than short-term issues, which poses a very serious problem for the Treasury. Many of you are doubtless aware that the last major Treasury financing consisted of two billion dollars of nine months' notes, one and one-half billion dollars of four year 4% bonds, and only one-half billion dollars of 10 year 4% bonds. The latter, only a token issue for Treasury financing, was apparently all the Treasury dared to offer.

2. During the last 10 years a very great increase has taken place in life company holdings of corporate bonds, these having more than doubled in the period, increasing from about 38% to 47% of assets. Life companies now own between 40% and 50% of the long-term debt of American corporations and they have been by far the most important supplier of loan capital to American industry.

3. Mortgage loan investments have increased very sharply in the last ten years, considerably more than tripling in absolute amount and increasing from 19% to 37% of invested assets of the 49 companies. Life companies now hold about 30% of the real estate mortgage debt of the country. They are probably the leading lenders on commercial property but are a poor second to the rapidly growing building and loan societies on residential loans, to which the latter are almost entirely restricted. It seems that interest rates on residential loans are, to an increasing extent, governed by social and political considerations, this being particularly true of government insured loans.

Life insurance company holdings of tax-exempt state and municipal bonds remain small at about 2% of invested assets. In the future this

may be sharply changed by tax considerations. In the case of The Lincoln National, over half of the increase in the bond account in 1958 was in the tax-exempt category. The supply of these tax-exempt bonds is very large and likely to continue so. In 1958 new tax-exempt issues totaled 7.4 billion dollars as compared with 6.5 billion dollars for all new corporate issues. There should be enough of them for all of us without our getting in each other's way. The effect of the new basis of taxation may very well be to increase the cost of corporate and mortgage borrowing by diverting life insurance funds away from taxable investments towards tax-exempt bonds. The extent to which this takes place will be interesting to watch.

Since corporate bonds make up the greatest single segment of life company invested assets, not much short of half of the total, a few more comments about trends in this field seem in order. In the five years ending with 1950, life companies were heavy buyers of public utility bonds, increasing their holdings of these at the rate of about one billion dollars a year on average and absorbing about two-thirds of the total increase in public utility debt during these five years. In the following five years ending with 1955, their net buying of these bonds was cut nearly in half and they absorbed only about one-third of the increase in utility debt. Since that time there has been a further slowing down in life company purchasing of utility bonds with the single exception of gas pipeline bonds. There are a number of reasons for this:

1. There is an increasing dislike for 30 year bonds without amortization, which is the way that utilities other than gas companies usually finance.
2. Because of regulatory pressure, the call protection on utility bonds tends to be relatively weak.
3. The yields on such bonds, particularly those sold at competitive bidding, tend to be lower than are obtainable elsewhere. However, in spite of this slowing down, the life companies still own about half of all public utility bonds outstanding.

Prior to World War II, industrial bonds were only a small part of life insurance assets. One reason for this was that the volume of such bonds outstanding was not great, only a few industries having any substantial amount of funded debt, of which the oil, steel, chemical, and meat packing industries were most important. However, since World War II there has been a very great deal of debt financing by industry. In fact, this has been by far the most favored way of raising capital by American industrial corporations. According to a recent SEC release, in the years from 1948 to 1957 more than three-quarters, or 33 billion dollars, of capital raised by these corporations was done through debt

financing other than loans from commercial banks. In addition to such direct debt financing, a great deal of such financing in disguised form was done through leaseback arrangements.

This trend towards debt financing on the part of American industry was probably stimulated by a number of factors:

1. Interest is a business expense before income taxes.
2. Interest rates have been at historically low levels, at least until the last couple of years, and even now they are not historically high.
3. The issuance of bonds rather than stock has helped to avoid dilution of the equity. In the case of some borrowers, the expectation or even the hope of further inflation may have entered their thinking. Such borrowers probably reason that if capital which does not seek to protect itself against inflation is available, why use any other kind?

As a result, the greatest increase in corporate bond holdings of life companies in recent years has been in the industrial and miscellaneous bond field. Such bonds now make up well over half of all corporate bond holdings of life insurance companies and well over one-quarter of their invested assets.

The great bulk, probably over 90%, of such industrial lending has taken place through the direct placement route. By this method it has been possible to negotiate better terms than are usually contained in bond offerings sold publicly and also to acquire bonds in very large quantities. Sometimes, but unfortunately too rarely, it has been possible to negotiate for stock options or convertibility in connection with such purchases, thereby imparting equity flavor to the investment. This great volume of industrial bond financing, of course, has not yet been depression-tested and maybe it never will be. Inflation tends to lighten the real burden of all debt, thereby lessening the risk of default. It is possible that some credit must be given to this factor for the almost default-free record of institutional lenders in recent years.

Corporate Bond Study

With nearly half of life insurance assets in corporate bonds, a study was published during the last year or so, dealing with the long-term experience of these bonds, which should have attracted more attention than it did. I refer to the Corporate Bond Study published by the National Bureau of Economic Research. This was in the nature of a large mortality study of corporate bonds, the only one, I believe, in existence. As actuaries, you should be interested in mortality studies. The study covered a total of 56 billion dollars of corporate bonds over the period from 1900 to the beginning of 1944. The record of such bonds since the

end of this study has been largely free from trouble. This Corporate Bond Study included all corporate issues of five million dollars and over and a sampling of smaller ones. I will comment very briefly on some of the facts revealed.

1. Corporate bonds in general have been pretty good investments insofar as paying the promised number of dollars is concerned. In spite of a substantial default rate, as a class they produced, if they were held throughout their troubles, a greater dollar yield than was promised. In other words, call premiums tended to more than offset capital losses. This was not true of rail bonds but it was true of industrial and utility bonds other than street railway issues. Of the total volume of bonds covered, 28% of rail bonds defaulted, 15% of industrial bonds, but only 6% of utility bonds other than street railway issues. The latter had a quite sad record and about two-thirds of them defaulted.

2. The record of utility bonds, leaving out street railway issues, has been unique. In cases where interest was covered at least 2 times at the time of offering, there were no defaults at all in the record. Even when such coverage was only 1½ times, the defaults were negligible. The record of such bonds was almost perfect regardless of the size of the company. This record seems to indicate that the risk in utility bonds is an industry-wide rather than an individual company risk. It makes the rating by quality of bonds within the electric, gas, telephone, and water divisions of the industry seem like a rather futile business.

With respect to industrial bonds, probably the most interesting point raised was that the size of the obligor is important. In the case of industrial companies having over 200 million dollars of assets, only about 3½% of bonds defaulted, while in the case of companies with under five million dollars of assets, 38% defaulted. This points up the hazard of lending to small industrial companies, an extra risk which does not apply to small utility companies.

Recent Trends in Finance

I should like to close with a few comments on current trends and conditions in financial markets.

1. If one could sum up the principal trend of financial opinion during the last five years, it would be that fixed dollar securities have lost popularity while equities have gained in popularity. The signs of this are everywhere today and I do not need to elaborate. About ten years ago one could purchase a cross section of public utility stocks to yield nearly 2½ times as much as the bonds of the same companies. Today many utility common stocks sell to yield less than highly rated utility bonds and the yield on a great many other stocks is now much less than is obtainable on intermediate term U.S. government bonds.

In the case of our own company, the regular cash dividend yield on common stocks bought in 1958 was nearly 1% lower than the yield obtained on taxable bonds purchased in that year. It was even less than the yield on tax-exempt bonds purchased in 1958. The substantial increase in stock prices since then would make the comparison still more extreme. The pendulum has swung a very long way indeed.

2. The market for bonds is tending to become increasingly restricted at a time when the demand for bond money has tended to increase. Corporate bonds in particular are now sold almost entirely in a captive market, the two most important elements of which are life insurance companies and pension funds. This captive market is probably not growing.

3. There is an increasing tendency to regard quoted interest rates as fictitious as compared with stock yields, some part of interest being viewed as an inflation offset. Stock yields, on the other hand, are based on only a partial payout of earnings, frequently under 50%, and in many cases are supplemented by extra dividends and stock dividends. American corporations are now paying out in regular dividends a much smaller proportion of earnings than was the case a generation ago. It required some such approach to the matter to justify present bond-stock yield relationships and maybe one should not try too hard to do so. Some stock prices appear to be discounting not only the future but the hereafter!

The fictitious nature of quoted interest rates over the last 18 years can be illustrated by calculating the real economic return on life insurance assets during that period. By economic return I mean the stated return less the annual percentage decline in the value of the dollar in which life insurance assets are largely stated. To satisfy my own curiosity, I made an attempt to roughly calculate this economic return. My calculations were quite possibly oversimplified and I apologize for mentioning them to an actuarial group. For one thing, they were based on interest return before income tax and, for another, they did not give weight to the changing dollar value of assets and particularly to the drop in the market value of fixed dollar investments which were put on the books at much lower interest rates than those prevailing.

For what they are worth, these rather rough calculations indicate that the economic return on life insurance assets over the last 18 years was probably negative in the order of ¼% to ½% per annum on average. For the eight years of heavy inflation from 1941 to 1948 inclusive, a substantial negative return averaging about 3½% per annum seems to have resulted. For the period of slower inflation from 1949 through 1958, a positive return averaging somewhat better than 1½% a year is indicated.

In conclusion I can only say that we are living in a period in which the conscientious and wise investment of trust funds, never an easy task, is faced with such difficulties as we have not heretofore experienced.

JOHN HAWKINSON:

The Role of Direct Placement Securities in Life Insurance Investment

For many years, the traditional method of distributing securities was through the medium of an investment banker actually purchasing or underwriting the issue and subsequently reselling the issue to investors and investing institutions.

As you know, savings have become increasingly institutionalized in recent years. This has been particularly true of bonds and debt securities.

Life insurance companies, pension trusts and certain mutual funds have become the all-important holders. Under these circumstances, it is only natural that the traditional process of purchasing and reselling a new security offering has frequently been simplified to one of direct negotiation between the issuer and the investor with or without the services of an intermediary.

The growing importance of direct placements in life insurance investment is illustrated by some statistics recently compiled relating to 28 major life insurance companies in the United States which hold approximately 80% of the industry's assets. In 1947, approximately 60% of the acquisitions of obligations (other than mortgages) by these companies was accomplished through direct placement. By 1957, this proportion had grown to 92% of all such acquisitions, and as of the 1957 year-end, 72% of all the corporate and municipal obligations held by these companies had been acquired by the direct placement route.

From the viewpoint of the issuing corporation there are often compelling reasons for taking this direct placement route. These may include the following:

1. The elimination of the uncertainties and the saving of time, staff work, professional services, printing and other substantial expenses involved in SEC registration and public offering.
2. Elimination or substantial reduction of underwriter's fees.
3. Assurance of confidential treatment of business and competitive information by limiting negotiations to one or a small group of institutions rather than the full public disclosure which accompanies public financing.
4. Achieving greater flexibility in the takedown and utilization of the financing proceeds. After a commitment letter or a purchase agreement has been negotiated with a responsible institution, the issuing corporation can draw down funds as required. This flexibility is a most important consideration in the case of construction projects requiring a long time for completion or where final costs cannot be accurately determined.
5. Often the issuing corporation or the proposed financing vehicle does not conform to the conventional investment standards required for public distribution. Under these circumstances, it is often possible to consummate the financing by direct placement as the result of full credit investigation and tailoring the financing media to the specific requirements of the institutional investor.

So much for the motivation of the issuing corporation. If the issuer can obtain such substantial and often inestimable benefits from direct placements, normal economic processes should permit the other party to these negotiations, namely the institutional lender, to obtain equally important rewards.

Let us examine these potential rewards in terms of life insurance investment requirements and as possible solutions to some of the industry's investment problems.

Of the various problems which complicate life insurance investment, I should like to consider the two which I believe have the greatest significance.

First, the problem resulting from wide fluctuations in the prevailing level of interest rates. A shift from the pattern of 4½%–5% interest rates on high grade bonds which prevailed in the 1930's to the level of 2½%–3% in the decade of the 40's and a subsequent transition to current interest rate patterns can have a most significant effect upon Company operations and earnings. Unfortunately, this effect is accentuated by prepayments and redemptions. It is a most disillusioning investment experience to devote several years to the development of a diversified securities portfolio affording a liberal rate of return only to have that portfolio refunded into long-term low income investments. In a period of sharply declining interest rates, such refunding can literally be accomplished in a matter of months. Even more disheartening is the long process of reestablishing the earning power of a low earning portfolio that has been so refunded. Issuing corporations are apparently quite ready to pay a sizable redemption premium for the privilege of refunding a 5% obligation at a 3% interest rate, but it is one of the strange anomalies of such borrowers that they are reluctant to refund a 3% long-term loan at 5% rate even though a very nominal redemption premium is involved. Therefore a very significant proportion of many life insurance portfolios are comprised of 2¾% twenty-five year to thirty year high grade bonds without the benefit of a sinking fund or required amortization. The equivalent market value of such a bond at current interest rates is approximately 74 or a liquidating figure about 25% below book value. Unless capital losses become somewhat more attractive than at present, or unless life insurance company surplus positions become quite redundant, this type of high grade investment will remain a rather permanent part of many life insurance company portfolios for our generation. Under the conditions I have outlined, significant changes in the prevailing interest rate patterns can be painful to life insurance managements and constitute a significant investment problem.

A second significant investment problem arises from creeping inflation. In the period 1940 to 1958, the value of the dollar has declined about 55% or at an annual compounded rate of discount in excess of 4%. Unfortunately, this exceeded the life insurance industry's investment earning rate through much of this period. It is indeed fortunate that policy

obligations are payable in a fixed number of dollars as units of account, but quite apart from the industry's ability to meet minimum dollar contractual obligations. We, as life insurance company officers and employees, must look a little wistfully at the alternative of common stock investment. During the same period, 1940 to 1958, the representative stock averages increased over 400%, an appreciation equal to an annual rate of 8% compounded. In addition, these stocks afforded an annual dividend income exceeding 5% per annum.

Unfortunately, neither applicable investment statutes nor the attitudes of most life insurance managements permitted significant investment in common stocks during the period 1940 to 1958. Today we still have the problem of restrictive investment statutes and the additional problem that, by all historical statistical standards, common stock prices are at levels that appear too high for major commitment at current price levels.

Now let us consider the application of direct placement investment to the two problems which I have outlined: first, to the problem of major changes in prevailing interest rates resulting in rapid refunding of portfolios during periods of declining rates and the nonliquidity of portfolios so refunded. It would appear that this problem can best be remedied by emphasizing liberal yielding investments with regular amortization over a ten to twenty year period, providing an average life of five to fifteen years. Such contractual repayments permit an averaging of investment experience by supplying a significant amount of cash for reinvestment each year. Such contractual amortization, when combined with noncallable or high call premium provisions, provide a large measure of insurance against losses through early refunding in periods of declining interest and against frozen and nonliquid portfolios during cycles of rising interest rates. Unfortunately, such attractive investment packages, providing favorable amortization at the principal amount and refunding protection, are seldom available in the public market and must be obtained through direct placement investment.

Let us now consider the second problem, dollar shrinkage in periods of creeping inflation and the difficulty of satisfactorily hedging against such inflation under present investment laws. This problem is further complicated by the very high level of stock prices in relation to present and prospective earnings. Here again aggressive direct placement lending can provide a partial solution. Many, if not a majority, of direct loan applications contemplate a rather high debt ratio to the borrower's capitalization. Under these circumstances, debt securities are expected to provide a portion of the funds previously supplied by equity. High corporate income tax rates have encouraged this trend. Under these

circumstances, it is entirely appropriate for the lender to require participation in an equity reward.

Such equity reward can be obtained by providing that the debt securities be convertible into common stock at agreed prices during the five, ten or twenty year period. Under these circumstances, the lender enjoys the security, contractual amortization, fixed maturity and interest return characteristics of bond investment. The lender has the very important additional advantage of a substantial equity reward, in the event that the borrower's stock appreciates in market value, equal to the market appreciation of the issuing corporation's stock. The number and volume of direct placement issues affording both the advantages of a creditor position and the corollary benefits of equity ownership have steadily increased in recent years. In our own Company investment operation, approximately 30% to 35% of our current commitments carry this equity reward. Now it must be recognized that convertible issues and issues with attached stock purchase warrants or various other types of equity participation financing are not exclusively confined to the direct placement market. However, it has been my experience that the equity participations available through direct lending have been generally more rewarding and available in larger volume than have similar issues in the public new issue market.

We have thus far dealt with a few of the salient advantages of direct placement financing. We have not considered some of the well publicized disadvantages of this type of financing. Perhaps the most widely discussed disadvantage is the alleged sacrifice of quality.

Traditionally accepted standards of investment quality may have considerably less importance than is commonly believed, as evidenced by the data which Fergus McDiarmid has presented to us. But in the type of direct placement investment operation which I have been discussing, let's admit that there is some departure from traditional standards of extremely conservative capitalization, historically stable earning power, long established corporate entities, seasoned management, etc. As you gentlemen know, traditionally high grade publicly offered corporate bonds carry twenty-five to forty year maturities. Often the instruments under which they are issued provide for no sinking fund or other form of amortization during their lives. I think we would be very well justified in considering the question of whether or not a lower quality obligation, fully amortizable over a ten or fifteen year period, providing an average life of five or ten years, does not provide fully as great investment safeguards as the traditional high grade thirty or forty year bond. Within the last three to four years, one of our largest life insurance companies

loaned the sum of $50,000,000 to a major domestic tire and rubber company. This was a $3\frac{3}{4}\%$ loan maturing in 2055. There is no requirement for amortization, but after a given number of years this loan can be converted into a twenty-five year maturity at a $3\frac{1}{2}\%$ rate with some required amortization. At approximately the time that this transaction was negotiated, our Company loaned a much smaller independent rubber company the funds to finance a Canadian operation. This loan was made at 5% interest and our loan instrument provided for full amortization over a fifteen year term. Subsequently, we arranged additional financing at a $4\frac{7}{8}\%$ rate, fully amortizable over a fifteen year period and convertible at our option into the Company's stock at $20 per share. Last night's close on the Company's stock was $46 per share. A few days ago, I had a conversation with a principal automotive design engineer who told me that in his opinion the automobile industry would develop within the next twenty-five years a turbine powered jet flow car operating without wheels. I have no assurance that his prediction will be realized. Fifteen years ago, I had no knowledge of the possibilities of nuclear power. I submit the question, is there greater hazard from fluctuation of interest rates, changes in technology, loss of competitive position in the hundred year loan to the Aa credit or in the fifteen year loan to a Baa credit? Our own experience indicates that the investment crystal ball is very hazy over the longer term repayment within a ten to twenty year period and is a very real source of investment protection. We believe that selected lower quality direct placement loans providing for ten to twenty year full amortization may provide greater investment security than thirty to forty year bonds.

A second problem referred to in direct placement financing is that of the heavy work load and the necessity for a large and competent staff. Direct placement financing does impose a much heavier work load upon the investment department. The burden of originating loans, investigating credits, trading and negotiating terms, review and supervision, together with the responsibilities of reviewing and supervising existing portfolio, imposes a much heavier work load than in a portfolio consisting of publicly offered securities or residential mortgages. Competence of investment staff is a prerequisite, but it appears to me that this is a relatively small price to pay for returns averaging $\frac{1}{2}$ of 1% to a full 1% above those afforded by publicly offered securities, favorable amortization, adequate redemption protection and substantial opportunities for capital appreciation. Apply $\frac{1}{2}$ of 1% interest rate return increase to your own portfolios and determine whether you would be justified in retaining the additional staff necessary to effectively handle the substantial volume of direct placements.

The third problem concerning direct placement investments which is often discussed is how one can obtain and assure a satisfactory volume. In my opinion, this is simply a matter of investment staff competence and management desire. It has been the experience of our own small Company that the volume made available to us is larger than we can process or absorb. We are not unique in this respect and many other medium size and larger companies enjoy a similar experience. I feel that there are four simple prerequisites to obtaining sufficient volume:

1. Make it known by conversation and by activity in commercial banking, investment banking, industry trade association and other channels, that you are interested in doing direct lending.
2. Promptly and efficiently process all applications. This means a prompt request to the borrower for the information required for your investment decision, prompt review of the material submitted and a simultaneous completion of trade and industry credit investigations.
3. Competent and realistic negotiation of terms to meet both your needs and that of the borrower.
4. Prompt indication of disinterest, rather than procrastination, on any application not meeting your investment requirements.

These are rather simple rules of conduct in many of the smaller and medium size Company investment departments and are far more often violated than adhered to.

I personally think these reasonable rules of conduct are not much different from the procedures followed by our respective Company underwriting departments: first, an indication that you are interested in obtaining business; second, a request for the specific data you require to process the risk; third, prompt processing of the data; fourth, acceptance or rejection of the risk without undue delay.

It would be most unfortunate if I have conveyed the impression that direct placements are the panacea for all investment ills. Such financing is not without its problems. These problems are readily surmountable with a qualified and competent investment staff. In my opinion, such activity requires greater staff competency and larger staffs than most other investment functions. The potential investment rewards obtainable from direct financing appear fully compensatory.

SANFORD M. THOMPSON:

Common Stocks

Common stocks have generally become legal investments for life insurance funds in the United States since the end of the war and this official endorsement may well prove to be one of the most significant developments in the business in modern times.

In Canada equities have always been legal investments and from time to time have been used extensively by Canadian companies, including our own. Our company's experience has been summarized by its President as rewarding, but frequently discouraging, and occasionally potentially dangerous if prudent limitations as to the amount so committed had not been present.

Legal limitation in Canada is 15% of ledger assets, a limit which my Company has not as yet found in any degree restrictive, as our general financial position has never been considered that strong. But there has been recently in Canada as in the United States a startling development in the enthusiasm of the endorsement of this medium for the investment of funds with objectives identical with ours, namely the "uninsured" corporate pension funds.

I am impressed by Mr. McDiarmid's Table 6 on page 586 of *TSA* X—a record of not only 3-fold growth in such funds in 6 years but a 6-fold increase in their equity holdings, to a total of $4¾ billion or approximately 25% of their assets. I am convinced that this rapidity of growth and their enthusiasm for equities are not unrelated.

However, little is known publicly of the actual month by month and year by year vicissitudes of common stock investment, as investment officers of our companies are understandably reticent. But without this knowledge, I suggest that the appropriateness of this investment medium, and the degree to which it can safely be pursued by life companies and others with the same objectives as ours, is impossible to assess. Accordingly, at the risk of personal embarrassment I should like to review my Company's experience briefly but over a considerable period, namely 40 years.

We have taken out an experience of the capital gains and capital losses on equities over a 40 year period December 31, 1918 to December 31, 1958. Common stocks owned on December 31, 1918 were taken into the experience at their then market value, but all subsequent purchases were added to the Fund so established at cost price and all sales were subtracted from the Fund at their sale price.

The Fund therefore indicates at any given year-end (or intermediate point) the total dollar amount at risk in the stock market at that moment.

Each year's gain or loss records the realized profit or loss on sale measured against actual cost, plus the market value appreciation (or minus the depreciation) of the year. Each year's gain or loss is carried forward and the cumulative gain or loss at any year-end (or intermediate point) can be measured in dollar terms or expressed as a percentage of the Fund at that point; but when the Fund is decreasing the measurement

is made to the previous maximum figure in the Fund. In short, the cumulative gain or loss may be expressed as a percentage of the maximum capital risked in the market up to the point of measurement.

I shall deal with our experience in three parts, the first being the 11 year period following the termination of World War I, namely December 31, 1918 to December 31, 1929.

December 31, 1918—December 31, 1929

This great expansive period commenced inauspiciously with a painful economic and financial adjustment from war to peacetime conditions.

The lush wartime earnings reported in terms of the Dow-Jones Industrial Average were $21 and $16 respectively in 1917 and 1918. In 1919 they were slightly lower at $14 but were halved to $7 in 1920, and fell to exactly $0 in 1921.

The "average" itself fell 47% between November 1919 and August 1921.

But prosperity was not to be denied. In 1922 earnings became $8, $11 in the next 2 years, $14 to $15 in 1925 through 1928, and $20 in 1929.

Initially prices lagged behind earnings, and in terms of the Dow-Jones Industrial Average the earnings yield in 5 successive years, 1922 through 1926, was generally 10% or better.

In the last 2 years of this 11 year period, this situation changed abruptly. Common stocks of the Dow-Jones Industrial Average doubled in market value in 18 months' time, earnings yields became as low as 5%, with the result that bond yields quickly overtook and then substantially exceeded dividend returns.

In retrospect there appear to have been 5 consecutive years of excellent common stock buying opportunities (based both on earnings yields and in their comparison with bond yields), and 2 years at the end afforded opportunity for sale of common stocks at considerable profit and reinvestment in bonds or other fixed interest obligations at a considerable gain in yield.

The 1929 crash is recorded in Mr. McDiarmid's Table 10 as a 48% drop, but it is only one of some 8 of comparable magnitude there tabulated, 4 of which took place in the first 20 years of the century, and as of December 31, 1929, 2 months after the crash, the Dow-Jones Industrial Average stood at 248, a figure approximately three times that of December 31, 1918.

Coming now to our own experience, our Fund at the beginning of the period, December 31, 1918, approximated 5% of assets.

Book values, however, were substantially in excess of market values,

a condition which continued for a further 5 years despite write-downs in book values meanwhile. Because of this and other financial problems incident to the readjustment period aforementioned, the Company lacked a sufficiently strong surplus position to exploit the opportunities of the years 1922–26 through further purchases in the stock market.

It might nevertheless have been expected that substantial gains might have been achieved through market appreciation and sale of the original portfolio in view of the tripling of the Dow-Jones Industrial Average from the beginning to end of this 11 year period. Although considerable sales were effected and our experience shows cumulative gain at the end of 1929, nevertheless it was *very* modest compared with the 200% gain in the Dow-Jones Average—a pointed reminder that skill in selection of specific stocks is also a prerequisite of successful stock market investment.

At the end of the period December 31, 1929, the Fund represented slightly less than ½ of 1% of assets.

December 31, 1929—December 31, 1944

We now come to the second part of our experience, the 15 year period 1930 through 1944.

It opened with the Dow-Jones Industrial Average at 248 but there soon commenced the awful sag in stock values, the stock market's advance notice of the coming complete collapse of confidence that closed the banks of this country three years later.

But 1930 was still not such a bad year, "prosperity was just around the corner," so the Company made significant purchases of common stocks in that year and again in 1931, although 1931 saw the emergence of the first of our corporate bond defaults. Meanwhile the "average" slid steadily and at these two year-ends was recorded successively at 164 and 78 respectively.

Came the deluge of defaulting borrowers in 1932 and 1933; a close margin between income and outgo; a preoccupation with our solvency; and a cessation of common stock purchases.

But with the gradual but halting recovery which commenced in 1934, we again resumed common stock purchases in significant amounts.

In the first 10 years of the period, up to the outbreak of World War II in 1939, we had made purchases of substantial amounts of equities in 8 of these years and the Fund at December 31, 1939 again represented 5% of assets.

Purchases through the war period were largely negligible in amount due to the necessity of marshaling all available funds for the war effort,

so by the end of 1944—the end of the period—the Fund had shrunk to 4% as a result of the growth in assets meanwhile.

At the end of this period, December 31, 1944, the Dow-Jones Industrial Average stood at 152.

In only one year of this 15 year experience, namely 1936, were our cumulative results significantly positive; at 11 year-ends the cumulative results were negative and in three years the cumulative results were so modestly positive as to indicate that the capital sum at that point was just intact.

As one of these latter results was that of the 1944 year-end, we might say that at the end of 15 years at least we had not lost any of our capital.

This 15 year period was featured by the necessity of almost continuous write-down of book values out of general Company interest earnings which were, as you know, falling rapidly over two-thirds of this period—a highly disciplinary experience.

As to dividend returns, about one-third of this period showed reduced dividend declarations and about two-thirds of the period was featured by dividends only modestly greater than current bond interest yields available.

As a consequence, the over-all extra dividend return on bond yield return was, in my opinion, quite incommensurate with the very serious administrative difficulties encountered with this account.

Conversely, the same amount of money as was committed to the stock market in this period could have been much more advantageously committed to the bond market, for the capital appreciation that would have been experienced, particularly in the long-term, noncallable sections, would have been very rewarding.

December 31, 1944—December 31, 1958

We come now to the last 14 years of our experience, 1945 through 1958.

As we entered the last year of the war, interest in the stock market quickened. The prospect of peace brought the hope for the fulfillment of goods and services long deferred, great expectations for peacetime adaptation of war-induced scientific discovery and technological development and, lastly, the promise of relaxation of tough wartime controls which seemingly had held corporate earnings within strict limits—earnings of $10 to $11 on the Dow-Jones Average.

In 17 months this "average" rose 50% to 212 in May 1946. At this point the $14 of current earnings of the index was only 6½%, but this was 1946, the year of adjusting the wartime machine to peacetime use, and

who could assess in dollar terms the stock market potential of postwar industry in terms of prospective earnings?

To my surprise, our General Manager ordered a reduction in our common stock holdings and 20% of the Fund was sold in this interval. At December 31, 1946 the Fund represented 2.3% of assets.

The 1946 decline was reflected in a 25% drop in the Dow-Jones Industrial Average. It is significant that this former 212 figure was not reattained until 4 years later. More importantly, however, the majority of common stocks listed on the New York stock exchange failed to reattain their 1946 highs until 8 years later, namely 1954.

Meanwhile, however, the $14 earnings of the Dow-Jones Industrial Average had bounded up to $19 in 1947, $23 in 1948 and 1949, and $31 in 1950, while from 1951 to 1954 they ranged between $25 and $28.

As a consequence, for some 7½ years the earnings yields on the Dow-Jones Industrial Average varied between 10% and 15% and in 4 of these years it was possible to buy the "average" on earnings yields of 12% to 15%.

While I have referred to earnings yields on the "average," it is worth noting some *actual dividend yields* on specific stocks at this time. Reading the financial pages of the press of December 31, 1950, for example, was like reading an account of Macy's basement bargain sales. DuPont was advertised to yield 6.37% (on the basis of its last four quarterly dividend declarations), General Electric 7.68%, Texas Company 7.93%, Bethlehem Steel 8.45%, Babcock and Wilcox 11.84%, General Motors 13%, Chrysler 14%.

Returning now to our own experience in the 8 years, 1947 through 1954, we made substantial net purchases of equities in 6 of these years and the Fund reached its maximum figure, in dollar terms about twice its previous maximum size, and, in relation to assets, constituted 5%.

From September 1953 to March 1956 the Dow-Jones Industrial Average made an almost continuous vertical climb from 256 to 521. While it subsequently fell by 20% in 1957, throughout 1958 it resumed its upward march, was 584 at the close of the experience, but since has penetrated 600.

Meanwhile, earnings on the same average which had been in a $25 to $28 range 1951 to 1954, increased to $36 in 1955, were $33 in 1956, again $36 in 1957, and approximately $28 for the calendar year 1958, although on the basis of the last quarter earnings of 1958 it was apparently earning at a $36 annual rate.

As prices have advanced disproportionately to earnings in the past 5 years, earnings yields have fallen markedly. Their yearly range based on Dow-Jones highs and lows of the year became 7%-9% in 1955, 6%-7%

in 1956, 7%–9% in 1957, 5%–6% in 1958, and at the close of the experience December 31, 1958, might be said to be approximately 6% on the assumed $36 annual earning rate of the last quarter of 1958.

Meanwhile, corporation bond yields in the United States have been reestablished on a 4½% to 5% basis, the best in 25 years.

On our assessment the market has moved with great rapidity from an undervalued to an overvalued status and, as a consequence, we have been a substantial net seller of equities in each of the past 4 years. As the aggregate of the sums realized on sale have outstripped sums committed to the market on new purchases during these 4 years, the Fund diminished rapidly, then became zero and at last year-end had reached "minus" figures.

This means that the capital committed to the market had at that point been recovered and some profit realized, part in cash and the balance represented by the value of the remaining portfolio.

The 40 years covered by the experience included a major war, two great expansive periods and a great depression. It covers a period which successively produced the philosophy of the "new era," that of the "mature economy," as well as the concept which one of your great banks has called "Horizons Unlimited." In short, a perfectly normal 40 years.

In detailing this experience I have referred throughout to the Dow-Jones Industrial Average and the earnings of this average as a matter of convenience and roughly illustrative of similar conditions, economic and financial, obtaining in Canada.

Canadian Equities

Canadian equities, which played an important part in this experience, but which at the end had been largely liquidated, deserve some special comment.

In the recent aforementioned 7½ year period, Canadian equities were also in a favorable buying range, particularly newsprint, lumber and base metal stocks, but in the case of many industrials they were less favorable in comparison with their United States counterparts. On the other hand, bond yields in Canada are always somewhat higher than in the United States.

For these reasons, the major part of the Company's portfolio in this last postwar period has been in United States stocks.

United Kingdom Equities

Since 1950, British equities have become part of our common stock portfolio. United Kingdom companies hold a relatively high percentage

of assets in this volatile medium, but significant differences in the manner of conducting life insurance business permit a higher prudent limit in equities there than here.

While in North America we guarantee cash and policy loan values, in the United Kingdom these are largely unguaranteed and discretionary. Consequently, United Kingdom companies in their domestic operations do not have to pay out a 3% cash value in a 5% money market and in times of financial distress, distrust or panic, they are largely immune to the heavy cash demands to which we are subject.

Again, policy reserves in the United Kingdom may be reduced if interest or mortality assumptions have proven to be unnecessarily conservative. The July 18, 1953 issue of the *Economist* reported that out of 18 British offices whose valuation year occurred in either 1951 or 1952, no less than 11, including the largest in the Commonwealth, did so change their interest assumptions and reduced their policy reserves, thereby permitting them to write down bonds by an equivalent amount to "market" but leaving surplus intact.

The foregoing are very important practical advantages which we in North America do not enjoy but which, in my opinion, permit of a higher prudent limit on equity investment by United Kingdom companies than we dare have under North American practice.

This observation should not be construed, however, as a general endorsement of the proportions of equities presently held by these companies, for the very wide variation therein is itself evidence of a considerable divergence of opinion as to the degree to which this volatile medium can be appropriately used.

Canadian Valuation of Bonds and Stocks

In Canada we largely follow British practice in respect to the valuation of both bonds and stocks. The official valuation standard is market value (except for government bonds) and in practice Canadian life companies report such assets at the lower of market or cost. The market valuation basis is a harsh taskmaster but is an official and pointed reminder of our responsibilities for the safety and supervision of policyholders' money. It tends to promote continuous and active supervision of a securities portfolio through sale and switch on the basis of relative values, without being inhibited by considerations of book loss. Canadian experience has been that such active supervision of the bond portfolio alone has minimized in substantial degree the capital loss on bonds incident to the increase in interest rates since the war, while common stock profits, where realized, have provided significant sums for the writing down of bond values.

Inflation

No discussion of common stocks today is complete without reference to inflation, but I shall be content to refer you to two eminent authorities. The Governor of the Bank of Canada has just said, "The idea that readiness to create or tolerate inflation can make a useful contribution to the problem of maintaining a high and expanding level of employment and output, is in danger of becoming the *great economic fallacy* of the day"; while your ex-Secretary of the Treasury, Mr. Humphrey, warned us not long ago that unless inflation is stopped, we shall have a depression that "will make our hair curl."