**TRANSACTIONS OF SOCIETY OF ACTUARIES**
**1960 VOL. 12 NO. 32**

# DIGEST OF INFORMAL DISCUSSION

## INVESTMENT POLICY AND INFLATION

A. Have companies invested in other than fixed dollar investments to the extent permitted by the laws under which they operate? If not, what considerations have led to their decisions?
B. What actuarial standards and practices would have to be changed for individual life insurance if laws governing the investment of life insurance company funds were changed to permit a substantial proportion to be invested in common stocks?
C. Does the fact that the contractual obligations of a company are stated in terms of fixed dollars lead to the conclusion that the company should invest exclusively in fixed dollar investments?
D. Assuming (1) that a stable price level is achieved and (2) that a method of valuing common stocks in life company statements is adopted which minimizes temporary fluctuations, would extensive investment of life company funds in common stocks be desirable?

MR. MILTON J. WOOD commented on certain broad aspects of the topic. He adhered to the traditional view that fixed dollar life insurance and annuity liabilities should be securely backed by fixed dollar investments, with investment in common stock being limited to a reasonable portion of company surplus. He noted that economic forces gradually tend to equalize the results and relative attractiveness between stock and bond investments. Although common stock investments are commonly considered to be made out of surplus funds, they are not so judged for the purposes of the new income tax law. As a result, the deduction of 85% of cash dividends on stocks is limited to the "life insurance company's share" thereof, so that the investment of surplus in common stocks in the case of a life insurance company is much less attractive than in the case of other corporations. The treatment of capital gains and losses in the new law is another important factor. On a long-term basis there is a strong possibility that a 25% tax will be paid on most of the realized gains, while the potentially large losses in a period of prolonged depression would probably entail no reduction in taxes since there would be little likelihood of offsetting capital gains in such a period even with the five year carry forward provision.

In discussing section A, MR. JOHN W. RITCHIE quoted seven reasons which had been given for the failure of life insurance companies to invest in common stocks to the extent permitted by law: (1) since common stocks must be carried at market values, sizable reserves or surplus and contingency funds must be held; (2) the legal rigidities pertaining to the valuation of liabilities are inconsistent with a security whose annual statement value can fluctuate widely; (3) the traditional adherence to fixed dollar obligations has made the preservation of principal one of the most important principles of the business; (4) common stock holdings can cause dividend distribution problems; (5) since prices will level out before too long if everyone plays his proper role in combatting inflation, the pattern of investment need not be changed because of a situation which is only an intermittent temporary inconvenience; (6) in the past few years the spread of yields between common stock purchases and other investment outlets has not been such as to justify acquiring stocks with their attendant greater risks; (7) successful administration of a sizable common stock portfolio necessitates the addition to investment staff of highly trained, highly competent specialists who are hard to find.

Mr. Ritchie expressed the opinion that there is some prejudice against common stocks in the life insurance business and that, if one does not start out with some small degree of enthusiasm for common stocks as an investment medium, a study of relevant comment is not calculated to make one a common stock convert.

MR. DENNIS N. WARTERS said that the lack of a guaranteed dividend, the lack of a fixed maturity date and the lack of a stable valuation basis for annual statement purposes make it difficult to justify any substantial common stock investment securing fixed dollar contracts. He pointed out that the astute stock buyer could select against the company through surrenders and loans during low stock price periods and thus force the company to sell at the worst possible time.

Commenting on section B, MR. RITCHIE and MR. REINHARD A. HOHAUS each referred to the practices in Great Britain where there are no statutory expense limitations and where complete freedom exists for the investment of funds in all available securities. In Britain, no minimum valuation bases for liabilities are prescribed, nor are there any prescribed bases for valuing the assets; therefore, British companies can reduce the amount at which liabilities are valued if there is a great reduction in the asset values reported for balance sheet purposes and thus leave the balance sheet showing a surplus. In addition, only about one quarter of the British companies guarantee cash values, and the basis of calculation gives substantially lower values than the reserve basis used. Surplus is distributed generally either as a percentage addition to the sum insured irrespective of age, plan and duration or as a percentage addition to the sum insured and existing bonuses irrespective of age, plan and duration. Because of these practices and provisions, British companies have been able to invest substantial percentages of their assets in common stock without endangering the companies; and comparable conditions would be essential if U.S. and Canadian companies were ever permitted to invest substantial proportions of their life insurance reserves in common stock. This would require revolutionary changes—legal and otherwise—the feasibility of which is nil.

Mr. Ritchie indicated that Canadian companies make large investments in bonds which are nonamortizable for annual statement purposes, all bonds except certain types of government bonds having to be valued at market, and also invest in common stocks, and yet are able to offer to policyholders the same types of guarantees that are offered by United States companies.

As to section C, MR. WARTERS stated that the answer could well be "Yes" insofar as assets securing fixed dollar liabilities are concerned. Where the liability contract is a long-term one under which the holder does not have the right to demand cash except at certain distant times, a case might be made for partial investment in common stocks.

MR. RITCHIE commented that though we would lose too much of proven value to our business if we discarded fixed dollar guarantees, it may be that we can improve our product by increasing our investment in common stocks. If we do not go too far, this can be done without too much risk. Evidence can be produced which seems to demonstrate that a well-selected portfolio of common stocks over a period of years will produce a higher yield than the average portfolio of bonds (see Table 1). There is also evidence that in an inflationary period common stocks afford some measure of protection against the falling purchasing power of the dollar (see Chart I).

MR. HOHAUS, reviewing the experience under three of his personal Ordinary life insurance policies, believed that others, like himself, who have carried level premium life insurance for many years as a form of basic protection rather than as an investment primarily, feel that the results have fully justified the traditional investment policies of life insurance companies.

Speaking on section D, MR. WARTERS said that in order to make such an investment desirable there would first have to be changes in life insurance contracts so that cash and other values were not guaranteed in fixed dollars. Also, we would have to move toward a method of valuing liabilities which took into consideration current interest rates and current prices insofar as they were used in determining the value of assets.

MR. RITCHIE, on the other hand, proposed that common stocks are essentially a long-term form of investment and therefore well suited to generating income for long-term commitments. Study of the liquidity needs of life insurance companies demonstrates that there is no necessity for insisting on a high degree of marketability for all sections of the investment portfolio. Accordingly, under the circumstances described in this

TABLE 1

COMPARATIVE YIELDS ON VARIOUS CLASSES OF INVESTMENT (UNITED STATES)
(based on mean of high and low yields in each year)

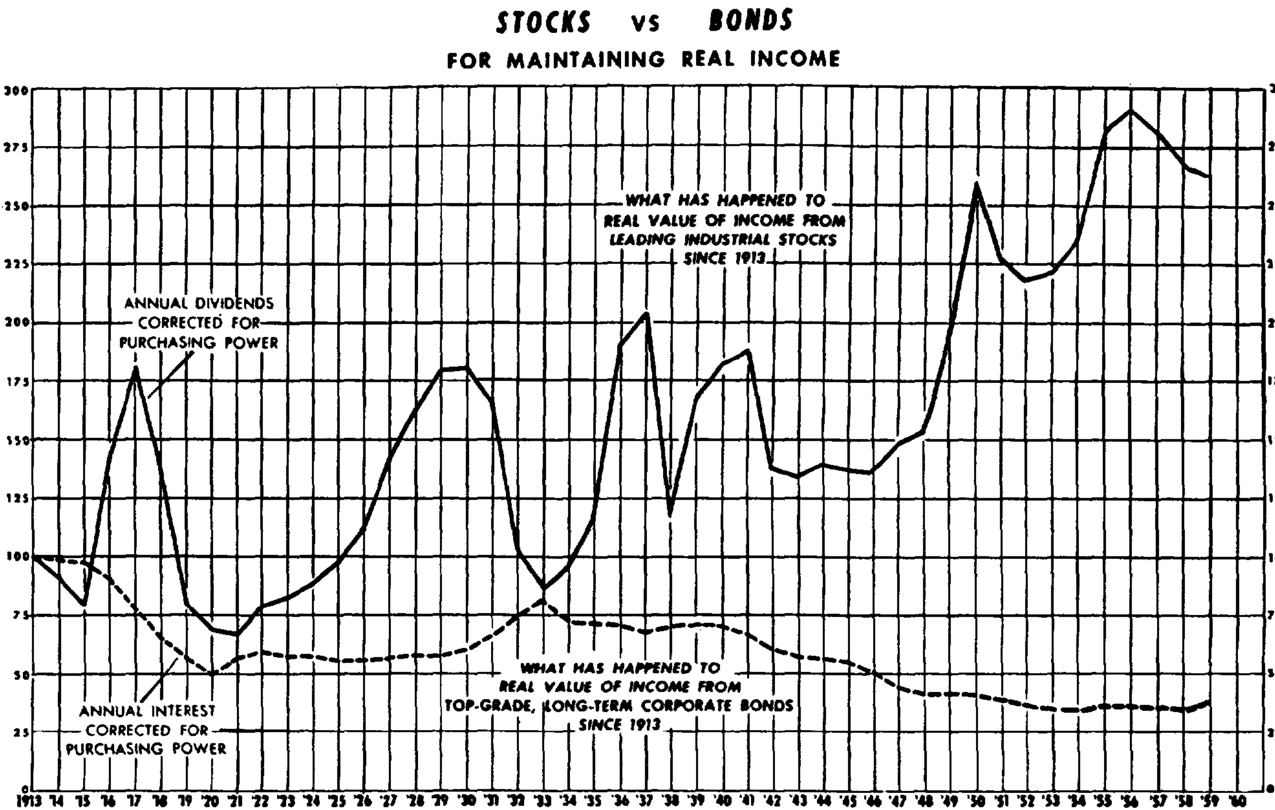
| | Municipal Bonds (1) | U.S. Government Bonds (2) | Corporate Bonds (3) | Preferred Stocks (4) | Mutual Funds (5) | Common Stocks (6) |
|---|---|---|---|---|---|---|
| 1946 | 1.51% | 2.19% | 2.53% | 3.53% | 2.34% | 3.98% |
| 1947 | 1.93 | 2.24 | 2.61 | 3.79 | 3.80 | 5.25 |
| 1948 | 2.35 | 2.43 | 2.82 | 4.15 | 4.49 | 6.44 |
| 1949 | 2.15 | 2.28 | 2.66 | 3.97 | 5.11 | 7.02 |
| 1950 | 1.90 | 2.32 | 2.62 | 3.85 | 4.71 | 7.48 |
| 1951 | 1.97 | 2.60 | 2.86 | 4.11 | 4.31 | 6.33 |
| 1952 | 2.20 | 2.68 | 2.96 | 4.13 | 4.10 | 5.65 |
| 1953 | 2.74 | 2.90 | 3.20 | 4.27 | 4.16 | 5.86 |
| 1954 | 2.38 | 2.52 | 2.90 | 4.02 | 3.76 | 5.10 |
| 1955 | 2.49 | 2.80 | 3.06 | 4.01 | 3.32 | 4.90 |
| 1956 | 2.80 | 3.06 | 3.36 | 4.25 | 3.25 | 4.65 |
| 1957 | 3.27 | 3.42 | 3.89 | 4.64 | 3.50 | 4.59 |
| 1958 | 3.22 | 3.28 | 3.79 | 4.46 | 3.20 | 3.92 |
| 1959 | 3.55 | 4.21 | 4.48 | 4.67 | 2.98 | 3.31 |
| 14 Yr. Average | 2.45% | 2.78% | 3.12% | 4.13% | 3.79% | 5.32% |
| March 1, 1960 Current | 3.65% | 4.25% | 4.60% | 4.81% | 3.26% | 3.34% |

SOURCES:
(1) The Bond Buyer's Index of 20 representative municipal bonds.
(2) Standard & Poor's Index of Long-Term U.S. Government Bonds.
(3) Moody's Index of AAA Corporate Bonds.
(4) Standard & Poor's Index of High Grade Preferred Stocks.
(5) Average yield on five leading U.S. Mutual Funds.
(6) Yield on the Dow-Jones Industrial Average.

question, we could raise our sights as to what constitutes a reasonable proportion of assets to have invested in common stocks.

MR. CHRISTOPHER H. WAIN mentioned that in approaching the question of investment in common stock it is important to consider the circumstances that have occurred in the general economic sphere as well as the past performance of the stock market. Among the many institutional changes which should give us some confidence that we do not face a recurrence of the extremes of the 1932 stock values are the increasing effect of social security in providing purchasing power throughout a re-

CHART I


STOCKS vs BONDS
FOR MAINTAINING REAL INCOME
WHAT HAS HAPPENED TO
REAL VALUE OF INCOME FROM
LEADING INDUSTRIAL STOCKS
SINCE 1913
ANNUAL DIVIDENDS
CORRECTED FOR
PURCHASING POWER
WHAT HAS HAPPENED TO
REAL VALUE OF INCOME FROM
TOP-GRADE, LONG-TERM CORPORATE BONDS
SINCE 1913
ANNUAL INTEREST
CORRECTED FOR
PURCHASING POWER
300
275
250
225
200
175
150
125
100
75
50
25
0
1913 '14 '15 '16 '17 '18 '19 '20 '21 '22 '23 '24 '25 '26 '27 '28 '29 '30 '31 '32 '33 '34 '35 '36 '37 '38 '39 '40 '41 '42 '43 '44 '45 '46 '47 '48 '49 '50 '51 '52 '53 '54 '55 '56 '57 '58 '59 '60

cession, the related growth of pension programs that help accomplish the same thing, and the growth of unemployment insurance which should help cushion the extremes of a business downturn. Also pertinent are developments that have acted as dampeners on the extremes of market fluctuation in terms of the regulation of security markets and the requirement of full disclosure of company developments, in addition to general government policy and indirect controls in the restriction of credit when business seems to be going too fast.