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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. ARTHUR PEDOE's discussion dealt mainly with the Canadian aspects of the topic.

He stated that at the end of 1958 Canadian life insurance companies (federally licensed) held 3.36% of their total assets in common stocks. A study by Mr. Pedoe of several large Canadian companies indicated that at the end of 1959 they held 2.56% of their total assets in properties acquired for the production of income. He further felt that certainly not more than half of this latter percentage represented "equities" rather than "fixed dollar" securities.

Since Canadian companies are allowed to invest up to 15% of ledger assets in common stocks and 5% of ledger assets in properties (real estate or leaseholds) acquired for the production of income, it is obvious that Canadian life insurance companies as a class are not availing themselves of the opportunities for "equity" investments permitted by law.

The wide swings of the stock market introduce an uncertainty which Mr. Pedoe feels can only be met by carrying what might be considered unduly large surplus reserves. For example, if it was assumed that companies did invest 30% of their assets in common stocks and a margin of 25% of market values was considered a minimum (*i.e.*, market values 33% above book values), such a margin would represent 10% of their total assets. This margin is generally considered as the maximum which life insurance companies should hold for all contingencies as well as fluctua-

tions in security values. In this case it would become the minimum which the companies should hold for common stock investments alone.

So long as market values of common stocks on a fixed date determine the financial position of a company, Mr. Pedoe felt that the proportion of other than "fixed dollar" investments would be kept to a nominal figure. The rigidity of operation of Canadian companies may have been necessary fifty years ago when present procedures were adopted, but Mr. Pedoe felt that it was time that these principles were re-examined. He then recommended that in Canada the principle of amortization of bond values should be extended beyond that of governments, and further that some system of averaging values of common stocks should be adopted.

Mr. Pedoe was worried about the trend away from the investment type of policies to term policies. He felt some effort should be made by the life insurance industry, both in Canada and in the United States, to capture the imagination of the public regarding its investment policy. He said companies should try to escape the criticism that "their investment equipment consists of a few pairs of scissors to cut coupons and a number of clerks to send out mortgage interest notices."

He was also concerned over the fact that the recent increase in purchases of "mutual funds" and other types of "units" by investors was capturing potential insurance sales, which in his opinion was an undesirable development that would be regretted in the future by many purchasers.

MR. MELVIN C. PRYCE felt that the reason Canadian life insurance companies haven't invested in other than fixed dollar investments to the extent permitted is due in part to the "trustee" nature of life funds and the fixed liabilities they must maintain.

He said that "equity" investments lose their appeal when more attractive net yields can be earned on mortgages and bonds than on stocks with their current inadequate returns which hardly compensate for risks in fluctuating earnings, dividends, and market values. In fact, the excess net earnings from fixed value investments over low yields on stocks may well offset any moderate long-term inflationary trend.

Mr. Pryce said that where there was once a world-wide demand for many of our capital and consumer goods and raw materials there is now a glut. Much of our prosperity in past years has been due to a strong domestic demand for articles and goods in short supply, coupled with a strong export market. Because of inflation, costs of production in the United States and Canada have gone up. At the same time other countries have re-established themselves as producers of many of the goods and raw

materials these two countries depend upon for a large part of their export trade.

As a consequence, Mr. Pryce felt the rate of new capital investment may slow down and the sales volumes of many industries may fail to show the year-to-year increase of the recent past. Prices may then have to be lowered to maintain sales volumes. However, because of our high cost structure, profit margins may well be squeezed. Thus, since inflation is not certain, Mr. Pryce concluded that a strong case cannot be made for substantial investment in stocks with their present inadequate yield.

MR. PEARCE SHEPHERD believed that it should be possible to invest funds in common stocks of well managed corporations and be assured of a growing income in the future. His belief was based on the fact that a corporation which pursues a reasonable dividend policy is retaining sufficient earnings to maintain a reasonable growth, which should be reflected in increased earnings in the future.

Mr. Shepherd then mentioned some of the difficulties of managing such investments. There may not be enough of the right kind of securities to meet the demand. The determination of the price at which to buy or not to buy is not simple. It may be difficult to place substantial sums in the market without pushing the price out of reason. Furthermore, the decision to sell is a difficult one.

He then pointed out the attractive features of some fixed dollar obligations which provide warrants, options to convert, or provisions for participation in earnings. He felt such securities may be a backdoor approach to equity investments.

Mr. Shepherd said that our practices of fixed valuation standards for reserve liabilities, strict standards for valuation of assets, and guaranteed withdrawal values make it dangerous to invest a substantial proportion of a company's funds in common stocks unless it is cushioned by a substantial margin of safety in surplus or contingency reserves.

MR. WILMER A. JENKINS, on section A, said that, among companies licensed in New York, there was a wide variation in the extent of their common stock investments. Among domestic companies, one had invested in stocks to half of the legal limit, one had practically no stocks, and several had invested to about 10% of the limit. Among companies domiciled in other states, he reported a wider variation—to as much as 80% and as little as 12% of the New York limit, most investing to one third or one half of the limit. TIAA had practically no common stock investments because of its unique relationship with CREF, which invests exclusively in common stocks. The two companies combined had approximately 20% of assets invested in stocks.

MR. HAROLD R. LAWSON said National Life of Canada had not invested in common stocks to the full extent permitted by law, because of the necessity of relating closely the amount of such equity investments to the level of the company's surplus.

In order to permit a substantial portion of a life insurance company's assets to be invested in common stocks Mr. Lawson felt current legislation would have to be revised to allow some arbitrary way of valuing stocks, such as the average value over a five year period. Alternatively, it would be necessary to relate the valuation of liabilities to the value of assets.

Mr. Lawson felt a life insurance company is not providing a complete service to its policyholders unless it maintains a reasonable diversification in its investment portfolio. This diversification he believed would require purchasing common stocks. As this cannot be done directly National Life of Canada is seeking to provide a more complete service by recently purchasing a 30% interest in a Canadian mutual fund.