INVESTMENT OF LIFE INSURANCE COMPANIES' FUNDS

VII.

Points to be Considered in Investments—Bonds I.

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The last article dealt with points to be considered when investing in mortgages. The following points should be considered when bonds of any description are being investigated:—

1. Although there are certain fixed rules for proper guidance in selecting a bond, yet, in order to be analyzed correctly, every bond should be considered on its own merits, e.g., because a mortgage is a first mortgage does not guarantee its safety.

2. Do not assume a bond is safe because it is secured on part of a large railroad system, and "underlies" one or more issues of secondary bonds.

3. A bond that is listed on a stock exchange is not necessarily safer or of better quality on that account.

4. Security.—In some cases a bondholder is absolutely protected by the pledge of property—in which case he virtually holds a mortgage—while in other cases he is more or less dependent upon the success of the business. In the latter case consider:—

(a) The company's earning capacity over a period of years. (b) The margin of safety over a period of years as demonstrated by the surplus earnings, and the relation of such surplus earnings to gross, net, and fixed charges. (c) The financial stability of the company—working assets and working liabilities. (d) The character of the lien of the bonds. (e) The relative proportion of capital stock and bonds outstanding. (f) What is the company's attitude in the matter of publicity?

5. What rate of interest does the bond bear? Is it subject to taxation?

6. When does it mature? Caeteris paribus, buy short-time securities when prices are high, and the net return consequently small, and buy long-time securities when prices are low and the net return high.

Convertibility and Appreciation.

7. Convertibility.—How easily may it be sold if the owner wishes to sell on short notice, or converted temporarily by hypothecation?

8. Appreciation.—What are the chances of the value behind the bond appreciating? Increased security would mean an advance in the value of the bond. It should be remembered that the prospect of appreciating in value of any bond depends a great deal on the activity of the market for that particular bond.

9. Study the earnings, not only at the present times, but in previous years.

10. What is the personnel of the directors? Are those behind the concern experienced, conservative, and honest men? This point is a very important one. A well-managed mediocre company is often to be preferred to an institution which, while theoretically sounder, is controlled by an untrained or vacillating management.

11. Is there any danger of political entanglements?

12. What is the prospect of competition, and what effects might competition have?

13. It is very easy to be misled by the manner in which a corporation's books are kept. For example, investigate carefully whether too high dividends are being paid on the company's securities, or whether sufficient charges are being made for depreciation.

14. The object for which the company is equipped must be considered. Is it alive to the effect of competition and changing conditions? What is the present and probable future demand for its products or services? If the company is a local concern, and affected by the population and industries of the community, ascertain their extent and the prospects of their increase or decrease.

15. Has due care been taken to prevent over-expansion and inflation?

16. What is the general reputation which the company enjoys among persons competent to appraise its management and progress?

17. Has the company been established long enough to enable you to make a reasonably accurate forecast of its future success? How has it passed through those crises common to its scope and area of operation?

Government Securities and Municipal Bonds.

When Government securities are thought of, market conditions should be studied, and it should be seen whether the security is selling above or below its normal value.

As to municipal bonds, consider:—

1. Legality.—See that the debentures are valid and proper in every respect. The entire municipality should be liable for the debenture debt.

2. Inquire into the past financial standing of the municipality and its future prospects, the character of its administrators, and how previous obligations have been met. What is the character of the population? For example, bonds of a municipality where there are frequent strikes should be avoided.

3. Other points:—

(a) The "net indebtedness" and its ratio to the assessed valuation. (b) Value and character of municipal assets, and revenue, if any, derived therefrom. (c) Situation. (d) Industries.—If the success of a municipality depends largely upon one industry, e.g., the lumber business, its bonds are not of the best. Conditions would be changed, however, if the industry were based upon some physical characteristic of the place (such, e.g., as the presence of great and inexhaustible coal mines), which renders the industry permanent. (e) Population.—If there is any danger of a decrease in the population, leave the bonds alone. Consider the surrounding country and its resources. Stability of population is increased by diversity of industries, and a municipality which is a natural thoroughfare of commerce has a distinct advantage. (f) Taxation.—What is the assessment and debt per head and rate of taxation? Is this rate becoming burdensome owing to over-rapid increase in the debt? The community may be experiencing a boom, and its debts increasing along the same lines. (g) Is there a sound "sinking-fund" plan or other method established for the ultimate payment of the bonds, rather than "refunding" the indebtedness? (h) What is the nature and amount of the debenture? Is it straight or instalment?

4. What rate of interest does the debenture bear? This should be compared with the ruling rate of interest in the given locality. A municipality which sells its bonds at so low a price as to yield the investor an income materially in excess of the ruling local rate of interest on time money—taking the average rate of four or five years rather than that of one time—thereby concedes that its own credit is poor, unless there is some special explanation.

5. Municipal securities are bought either through bond houses or by direct tender to the offering municipality. The circulars of bond houses set forth with much exactness most things necessary to know and relieve considerably the task of investigation.

Industrials as Investments.

The following are the points relative to industrial bonds:—

1. Where the security behind the bond consists in part of real estate, such real estate being substantially in excess of the bonded indebtedness, the obligation practically becomes a real estate mortgage.

2. Failing this ideal condition, we must look into the net quick assets, composed of current assets less current liabilities. Current assets should be at least double current liabilities, and, except in the case where real estate holdings are considerable, should be at least equal to the amount of the bonded debt. This is an important consideration, when it is remembered that a large part of the assets behind a bonded indebtedness may be almost valueless in case of a foreclosure, e.g., the plant, machinery, good-will, patents, etc. Also, the very reasons which make a company unable to meet its interest on other obligations make it also a difficult property to sell. As a matter of fact, the truth of the statement that the ultimate safety of the bondholder lies in the ability of his corporation to earn interest and other charges finds its greatest substantiation in the case of industrial bonds.

3. Has the company a product in constant demand, and, therefore, a steady business with regular earnings?

4. Marketability.—Some industrial bonds are much easier to market than others, and it should be decided beforehand whether this feature is desired.

5. In buying industrial bonds, the dangers that might be in competition or tariff legislation must not be overlooked. Determine the likelihood of such, and to what extent the business would be affected thereby.

6. How would the earnings of the industrial be affected by business depression? As a rule, the earnings of an industrial company are more acutely affected by business depression than are even those of steam railways, and the margin of safety needs to be considerably greater.

7. An industrial company whose bonded debt exceeds 50 per cent. of its total assets should not be considered strong enough to render its bonds attractive—unless, of course, its earning power possesses exceptional stability. In ascertaining the assets and earning power, a period of years should be considered to allow for years of depression as well as for normal or prosperous years.

8. A company producing necessities of life which enter almost universally into consumption is in a better position than one which produces luxuries or specialties of any kind.

Public Utility Companies' Bonds.

To determine the safety of public utility bonds we must consider three influencing factors: physical, financial, and political.

2. As regards the franchise, consider its length and nature and the powers conferred by charter on the company.