

INVESTMENT OF LIFE INSURANCE COMPANIES' FUNDS

V.

Stocks, Loans, and Real Estate

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By their nature, stocks possess the disadvantage, from an insurance standpoint, of unstableness in value. In times of severe depreciation the statements of a company with large stock holdings would be seriously affected, and it is difficult to value stocks by an "averaging" method and impossible to use the amortization plan. Stocks, as a class, yield higher rates of interest than bonds or mortgages; they sometimes offer great prospects of appreciation.

They do not rank with either bonds or mortgages from the standpoint of safety, although a well-selected cumulative preferred stock often ranks with the best bonds. Indeed, if a portion of the extra rate of interest yielded be looked upon as a "risk premium," the preferred stock of a well-established, prosperous concern might, as a profitable, conservative investment, rank ahead of the same company's bonds. However, it should be remembered that a corporation's bonds always have precedence in respect to security and dividends over its stocks, and are always safer, using the word in its strictest sense. As a rule, they are too speculative, particularly in the case of the common stocks, which depend almost entirely on the future success of the business. In a great many cases the common stocks do not represent actual money paid to the company, but may belong to the "watered" variety. A life company should avoid any stock where there is the slightest suspicion that everything is not "above board," and they are, indeed, well protected from that class of investments by certain prohibitory insurance laws.

Stocks have another serious objection, that their purchaser becomes an owner in the business, and if an insurance company obtained large holdings in any corporation, serious complications might arise.

Stocks, more than any other class of security, offer temptations to the seller or purchaser by way of speculation. The gambling instinct is inherent in all of us, and the management of any insurance company cannot be too careful in eliminating this element from its "make-up." At the same time, where the prices of securities that are perfectly sound in every way have dropped far below their intrinsic values, as, e.g., in the panic of 1907, I think such an opportunity to make large profits should not be ignored.

As to Policy Loans.

They form what may be called a "passive" investment; i.e., they are not sought after nor controlled by the management. If, however, the company finds that policies with loans against them have a greater tendency to lapse than is otherwise the case, they can do much to discourage the practice through their agents, literature, etc.

While the loan feature can be used as a canvassing argument, yet the wisdom of this course is doubtful.

If its policies are borrowed upon to any extent, the company may find it necessary to keep a larger proportion of its funds in easily-convertible securities, with a corresponding reduction in its interest earnings.

The loan privilege may cause trouble in a period of great financial stringency. The demand will be greatest during such a period, and securities can then only be disposed of at a loss. It is, therefore, well to have a clause in the policy deferring the loan for a short period at the option of the company.

The rate of interest charged should be as high or higher than that yielded on its funds, and elastic, so that it can be kept above the market rate. With companies earning 7 or 8 per cent. on their funds, the former course will be very objectionable to policyholders and discourage borrowing. On the other hand, it will lead to a higher rate of lapse among those who do borrow, and will also afford an argument for rival agents. In many cases, however, the rate of interest chargeable on policy loans is fixed or limited by insurance laws. The security for these loans is absolute, and, as there is practically no expense in the handling of the loans, the gross rate may be looked upon as a net rate.

As to Collateral Loans.

The rate of interest is low; they require considerable watchfulness; they are a safe investment, provided sufficient margin is allowed. They afford a favorable opportunity for getting a fair interest rate on funds awaiting permanent investment, and should be used only for this purpose. It might be deemed advisable, however, to have such liquid assets as would enable a company to meet demands in excess of its current receipts, and investments in "call" loans would come in very timely in case of sudden and abnormal demands for policy loans or cash surrenders in a period of financial stress. A company might thus be in a position

to meet such demands without disturbing any of its permanent investments.

Office premises are desirable when a company is large. Any unused portions can be let, and the company has the additional advantages given by the prestige and greater convenience that can be obtained from a permanent head office building. It is a mistake for a young company to invest in an expensive head office building. In this connection Zartman says: "Those companies who have had other weak elements in their management have been ruined by the heavy burden of a costly home office, and in a number of cases these magnificent buildings stand not as monuments of strength, but rather as tombstones to departed companies."

The interest rate earned has been very unfavorable, but there are reasons for this. Companies have not been permitted to invest freely in real estate. Consequently, the majority of real estate holdings consists of office buildings and that acquired under foreclosure. It is, therefore, hardly reasonable to condemn real estate investments on this basis. Had the companies been able to invest freely in real estate a much better showing would have been made, as instanced by the French companies. And again, companies may have had losses on account of foreclosed mortgages, which losses may have been charged against real estate instead of against the mortgage account. Another reason for the low interest rate shown may be adduced from the practice of some companies of charging themselves with a very low rental for the space occupied by themselves in the head office building, thus making the return on their real estate apparently small.

But it must be admitted that real estate calls for considerable care, and depreciation losses are also great. The net interest rate earned is, therefore, considerably below the gross rate.

In a growing and prosperous community no doubt great profits could often be made through real estate investments; but such investments lead to much speculation, and the present restrictive laws seem just.

Touching lightly on the subject of legislation, I may state that there seems to be a growing tendency in the States and Canada to restrict the freedom of investment. Perhaps those laws, similar to the Robertson law of Texas, that endeavor to compel companies to invest given proportions of their funds in certain districts, are the most to be feared. In this connection Mr. R. L. Cox says: "During 1911 measures were introduced in four states to restrict the investments of foreign insurance companies geographically along the lines of the Robertson law of Texas. . . . When the Robertson law was enacted by Texas in 1907, twenty-three—nearly all—of the leading foreign life insurance companies doing business in that state retired. This law requires that 75 per cent. of the reserves set aside to meet obligations to Texas policyholders shall be invested in certain specified local securities. The avowed object of the law was to compel foreign companies to make investments in Texas. This made statute utterly ignores the natural law of supply and demand, affecting the flow of investments. It also takes from the managers and trustees of life insurance funds the right of exercising their judgment as to investments, although it does not relieve these managers and trustees from being responsible if the compulsory investments should prevent their companies from meeting the test of solvency. . . . Beginning with 1907, the subject of such compulsory investment has been considered in twenty-four states, either in the form of legislation actually introduced or talked of seriously among state officials."

In Great Britain the companies are not restricted in their investments. As one writer has expressed it: "Freedom and publicity is the English theory; paternalism and publicity is the United States result; supervision and publicity is the Canadian practice." Personally, I hold the opinion that broad, general laws should exist, limiting the field of investment. It might be argued that such laws are more necessary in the case of the American companies, where competition is more rife, and managers more eager for leadership, than in the case of their more phlegmatic British and over-conservativeness. However this may be, it seems right that the powers of investment should not be restricted within too narrow limits. New forms of safe and advantageous investments are constantly arising, and some latitude should be allowed to the sagacity and ingenuity of the management. A too limited area would lead to over-concentration in certain lines of investment, with consequent decrease in the rate of interest obtainable. Since, however, a life company's funds are to a certain extent in the nature of "trust funds," the law should see that the investments are made in securities of unquestioned value, and that the element of speculation is entirely eliminated.

Mr. Rose, in the proceedings of the international congress of actuaries, says, "In the end, manifestly what tells in the choice of investments, as in every other department of the life insurance business, is wise and prudent management, and no general principle can take its place: neither can hard-and-fast rules be laid down for different companies with different conditions, or for the same company at different periods in its history, when conditions may have changed for it. Still, it does seem, especially in view of