

INVESTMENT OF LIFE INSURANCE COMPANIES' FUNDS

IV.

Bonds

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Having dealt with investment of a company's funds in real estate mortgage loans in the previous article, I will now consider the advisability of investing in bonds.

Bonds have a very tangible and substantial appearance on a company's statement, and yield a fair rate of interest;

They possess in many cases a prospect of appreciation;

They are usually readily convertible, i.e., by selling on the market, or assigning as collateral. This point has to be especially considered by those companies whose policyholders make very free use of the loan privilege;

They can be used in most cases (and are required as well) for government deposits;

They run for a long term of years, thus doing away with too frequent re-investment of funds, with the greater risk thereby entailed of a poor investment slipping in accidentally.

They bear a fixed rate of interest—an advantage in times of falling interest rates, and the reverse when interest rates are rising;

They entail very little labor, with no difficulty in collection of interest or principal.

On the best bonds, the interest rates are too low for very large holdings;

In case of default, the bondholder has to co-operate with other bondholders to obtain his rights. On the other hand, the insurance company is probably one of the largest holders, and moreover with the modern devices of re-organization committees, the insurance company might be occasioned less direct trouble than in the case of a mortgage foreclosure.

Their value, as represented by market quotations—which quotations indicate the average verdict arrived at by a great multitude of investors—must, as a rule, represent very closely their intrinsic worth.

While not as stable in value as are mortgages, they are more so than are stocks. A decline in value, which may or may not be only temporary, and undeserved, will nevertheless cause difficulty in arriving at their true value in a company's statements;

By carefully considering market conditions before making a purchase or sale of bonds, a life insurance company can sometimes make large profits due to market fluctuations. But this might be looked upon as a disadvantage in the sense that a company might be led into speculation—a danger above all others to be avoided by a life insurance company.

An investment in bonds may be made with great facility and expedition, and in this respect they are to be preferred to mortgages, since the money ready for investment is left idle for the shortest possible time.

As Between Different Classes of Bonds.

Bonds having only a short time to run before a fixed maturity date, will naturally not fluctuate greatly in value, and on this account, have an advantage over long-term bonds. Again, they may sell on a somewhat more favorable basis, owing to less demand for them, since the ordinary investor in bonds is looking for a more prolonged investment. As a rule, however, insurance companies prefer long-term bonds. Mr. T. B. Macaulay, referring to "length of time," says, "If the assumption be granted that the existing period of prosperity is not to last always, it seems to me that it is hard to escape from the conclusion that it is good policy to pass by all short-term securities unless they yield unusually attractive rates of interest, and to select those which run for long periods—25, 40, or 50 years—or, better still, perpetuities such as the guaranteed or preferred stocks of established and prosperous corporations. In this way it is possible to ensure that the high rates of interest now prevailing will continue far in the future on the investments now being made." From this we can deduce the axiom, "Other things being equal, 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."

A point to bear in mind is that the best known securities, and those most readily convertible, will, for those very reasons, fluctuate more in financial crises than those securities of perhaps equal value, but which are not dealt in, to such an extent, on the Exchanges. Securities of the smaller cities or towns, e.g., have shown less depreciation than has been the case with other bonds.

If now we take the large security holdings of any company and rank them from the standpoint of safety, they would probably range as follows: Government, municipal, railroad, public utility (other than railroad), and industrial.

In buying government securities, a company sacrifices a good interest rate for unexcelled security. Too much competition on the part of banks, trustees, etc., has reduced the yield on government securities to a figure so low that very large holdings on the part of life insurance companies are prohibitive, and their main use is for government deposits. Besides their absolute safety, however, government securities are not without their advantages. They lend prestige to a company's statement, are readily convertible in case of need, are very stable in value (very seldom being subject to wide variations), and supply a permanent investment for a company's funds. Moreover, United States government bonds are non-taxable in all parts of the United States, either by government or municipality.

Security is Good.

The security behind municipal bonds has increased enormously in recent years, and the best municipal bonds are really gilt-edged, and consequently they usually sell at a higher premium than do bonds of railroads and corporations. A great deal of the credit for the improved position of municipal bonds is due to the bond-dealers, who have been instrumental in improving the laws regulating their issuance and in forcing the municipalities to live up to them, and who have discouraged excessive debt creating even where legally permissible. Municipal bonds are among the most stable of the securities from which the investor may choose. They are sometimes difficult to negotiate in cash, due to the fact that there is no open market for them, but it is an easy matter to raise money on them from the banks; and, moreover, bond-dealers can often find ways of disposing of them.

Railway bonds of the better class are held in high esteem by insurance companies, as evidenced by the large number purchased. Some of them, indeed, are of only secondary merit to government issues. The bonds being so well secured, naturally sell at a high premium, and on the whole do not yield a rate of interest much in excess of that to be obtained on good municipals. They are, however, more easily convertible than any other security, they run for a considerable number of years, have a wide market, and their potential appreciation is high. Railroad stocks are usually very speculative, yet in some cases the stocks are better investments than the bonds.

This would be the case, however, only with those roads that have passed through their experimental days, are now firmly established and that have shown they can earn their dividends in times of depression as well as in prosperous periods. When considering the purchase of any of the securities of a railway, too much stress cannot be laid on the fact that railroads are transporters, not producers of wealth, and that their earnings fluctuate greatly with the business conditions of the country. During a long period of depression, the safety of many good railroad bonds will be strained to the utmost, and the stocks of even the best roads might fall helter-skelter on the Exchanges. Another point that should not be overlooked is that of government interference, which, if carried too far, may make even standard railroad bonds less desirable than some other forms of investment.

Wide Field for Selection.

We now come to the consideration of the securities of public utility corporations (such as gas, electric light, telephone, and so forth). The rate of interest obtainable on public utility securities is a little better than in the case of municipals and railroads, due largely to the fact that the public is not so familiar with the former. The great majority of these securities are not listed on any exchange, and, therefore, they have the advantage pertaining to all unlisted securities of not fluctuating so widely in value. But very frequently they have a wide market and this is one of the factors in keeping down their interest yield.

Numerous public utility securities can be obtained offering everything required by way of security, but it must be remembered that the most careful selection must be made, for there are good, bad, and indifferent public utility securities, just as there are all sorts of railroad and industrial securities. The question of the franchise, and to what degree the corporation is or may be subject to political or municipal interference, must always receive the utmost attention. But the field for selection is wide and must necessarily increase with the development of the country, and particularly with the growth of the cities and towns.

For and Against Industrial Securities.

Turning to industrial securities, we find ourselves dealing with a more speculative class of investment. The success, or otherwise, of most industrial concerns varies closely with that of the community at large, its earnings being greatly affected by business conditions. Industrial securities are, therefore, not very stable in value, but, on the other hand, many of them present great prospects of appreciation. Views differ widely as to the merits of industrials.

One writer states: "Industrial bonds are rarely purchased by the most conservative life insurance companies. They