INVESTMENT OF LIFE INSURANCE COMPANIES' FUNDS

III.

Real Estate Mortgage Loans

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The question as to the advisability of investing the majority of a company's funds largely in bonds and like securities, or of adopting the other course, and investing most largely in real estate mortgages, must now be considered. Both sides of the question have staunch supporters, and I think the question can be dealt with by giving the comparative advantages and disadvantages of one class of investment as compared with the other. In doing so, I will also touch lightly on various points in connection with other minor investments.

Dealing first with real estate mortgage loans, we may state that:—

The rate of interest obtainable is perhaps higher, commensurate with safety, than any other form of investment permissible to life companies. In order to obtain the best rate of interest, however, the mortgages should be well chosen, for rather small amounts, and to a large extent on good farm property.

The funds are permanently invested for a number of years at a fixed rate of interest, and cannot be repaid without a substantial bonus as a recompense.

Does Not Fluctuate.

The value of property, carefully selected, does not fluctuate to any extent. Moreover, if there is this tendency, or if there is a remote possibility of depreciation, it can be guarded against by arranging for an annual repayment on account of the principal.

Mortgages frequently lead to large life policies, as additional security for the loan. A note of caution, however, should be sounded here, "Do not overload the borrower with payments. You may swamp him."

A mortgage loan is less affected by financial stringency or panic than any other security. (It is "news proof.")

As one writer has said, "It is secured by tangible physical property that cannot be juggled from under the mortgage, dissipated or stolen, and that will not wear out, depreciate, burn up or blow away. It is not subject to legislative attack or official investigation; not dependent upon public franchise; its value is not depreciated by destructive competition or corporate mismanagement; not affected by 'good will,' 'watered stocks,' 'future earnings,' or 'contemplated improvements.' "

Care and Investigation Needed.

Mortgages call for a great deal of detail work and investigation. This should not, however, be a disadvantage in the case of a large company, though it would in the case of the individual investor. The extra expense entailed would, nevertheless, require consideration when figuring on the net rate of interest to be realized.

Great care has to be taken in the selection of the property on the security of which a loan is made. What are the chances of depreciation? Do the values of property of that class, or in that neighborhood, have a tendency to fluctuate? Are the mortgages too centralized, instead of being spread about in different districts?

In the case of foreclosure, the company is in danger of heavy loss on the investment, though this can be guarded against if a sufficient margin is maintained between the value of the property and the amount advanced.

Too great a proportion of the company's funds should not be invested in mortgage loans. Sudden depreciation in land values may result ruinously to a company, overdoing this "good thing." Again, owing to the comparatively short terms of mortgages and consequent necessity for frequent reinvestment of repaid principal, falling rates of interest would affect such a company to the greatest degree.

Changes in Interest Rate.

A disadvantage which mortgages share with other investments which have to be replaced every few years, is the greater chance of an ill-chosen investment slipping in at some time. This is one point in favor of long-term bonds.

I referred above to the high rate of interest obtainable on mortgage loans. Suppose, however, that interest rates are falling. Our mortgage loan would be repaid in a comparatively short period of time and the repaid principal could only be reinvested at the fallen rate of interest. A bond, however, owing to its fixed dividend and distant maturity-date, would be correspondingly enhanced in value. This brings us to a point requiring great nicety of judgment. Is the rate of interest in the future likely to be lower, and if so, to what extent—questions involving endless discussion of theoretical and practical nature? These points determined, we then enquire, "Will the higher temporary rate of interest realized on the mortgage be sufficient compensation for the brevity of the term during which that rate is likely to be paid?" In other words, "Will the accumulated amount of the mortgage at the end of its term of N years be equal to the enhanced value of the bond that could have been purchased in its place N years ago?"

One advantage that the bond has over the mortgage is the ease and certainty with which the interest is collected. Particularly in respect to farm mortgages, is there a matter of frequent difficulty in keeping the interest payments from falling into arrears.

Question of Appreciation.

Another advantage that the bond has over the mortgage, and one that will appeal to a very cautious management, or one lacking in initiative, is that its value has been fixed by the concensus of many minds. It will, moreover, probably be recommended by a reliable and experienced firm of brokers. The value of a mortgage is more a matter of individual judgment and investigation.

A point in favor of mortgages is the stability of their values. Bonds and stocks are quoted in the market, and frequently very considerably in price, and it is difficult to fix their true value on a company's balance sheet. A real estate mortgage may be difficult to dispose of at any price, but there is nothing by which small changes in its value can be gauged, and consequently it may stand on the company's books at its par value, unaltered from year to year—decidedly an excellent feature.

Marketability of Securities.

From the standpoint of "marketability" the bond or stock is to be preferred. But this very lack of ready marketability has been one of the factors in keeping the yield on mortgage loans so high. Moreover, as pointed out elsewhere in this paper ,"marketability" cannot be looked upon as of great importance in the investment of a life company's funds.

We can next consider the question of appreciation (apart from fundamental changes in the interest rate). A mortgage loan has no prospect of appreciation. True, the security behind the loan may improve, but this should be sufficient at the outset of the loan. But, no matter how much this security may appreciate, the mortgage lender will not receive one iota more by way of interest or principal. On the other hand, an appreciation in the security behind a bond, or in the value of a stock, is at once reflected in the market price; the value of the bond or preferred stock advances by reason of the increased security; the value of the common stock advances by reason of the expectation of an increased dividend.

The element of speculation is reduced to almost a minimum in a carefully-selected mortgage loan. Bonds—excepting those of the highest class—and stocks, in particular, have not this advantage to nearly the same extent.

Valuation Must Be Conservative.

Another point may be given in favor of the mortgage loan over the bond. The mortgage holder can, in all cases, enforce the provision that the security be properly maintained; while the bondholder must rely upon the action of the trustees and other bondholders. In event of default, the mortgage holder may foreclose and act independently of others; the bondholder, in such an event, must co-operate with the other holders, and be dependent upon whatever action the majority of the holders wish to take. This is, however, a great objection from the standpoint of the individual investor than from that of a large life insurance company.

In certain states, laws regarding mortgages, distinctly unfavorable to the lender, have been enacted. This disadvantage, however, is only a local one, and can in most cases be avoided, by lending on real estate located elsewhere.

Owing to the location of their head office, some companies find it necessary to go far afield in search of the best real estate mortgages. Here we have the disadvantage that the investment is not made under the eyes of the management. This is not a great objection, however, if such mortgages be limited to those sections where a company is well organized, and doing an active insurance business.

In relation to the fluctuating values of real estate, the following point may be given. As stated before, the mortgagee will not benefit financially by an appreciation in the security behind the loan. A marked depreciation, however, may lead to foreclosure and probable loss to the lender. Hence, in connection with the mortgage loans, always bear in mind, that the maximum benefit which can be derived, is the interest, while there is always the possibility of a substantial loss of principal. The following note of caution may, therefore, be sounded, "Be conservative during these times of 'inflated values' in your valuation of the security behind the mortgage, and in the percentage you advance on this conservative valuation."

Generally speaking, mortgages in towns or villages are not as safe as those on city property or on farm lands. Town and village properties are subject to the success or otherwise of the district surrounding them. In the event of a forced