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A Policy Holder Looks at Investments

Life insurance is essentially vested with the public interest. Whether a company is stock or mutual in form, it is generally recognized that it must be conducted primarily in the interest of its policy holders. It is the policy holder who makes the business possible. It is the policy holder's money which makes the business run. The policy holder deserves a full and candid report of his company's operations both from an insurance and an investment point of view. He is entitled to the kind of reports which will provide him with a fair and accurate basis upon which to compare the operations of one company against another, organized in a manner to aid him in the selection of that company to which he will entrust his savings. These are the premises of my talk.

The reports of the companies customarily rendered to their policy holders do not at present provide a basis for detailed investment analysis. Many companies, including some of the larger ones, do not furnish information regarding their financial position to policy holders, except upon specific request. Of 323 companies studied from this point of view, it was found that 64 do not regularly furnish policy holders financial reports of any kind, 192 issue condensed balance sheets only, while 61 regularly issue more complete data, including information on their bond and stock portfolios. None are known to furnish policy holders any detailed information on mortgages or real estate. The inquisitive policy holder, therefore, will probably find it necessary to journey to his state capital to peruse the detailed annual reports required to be made to state insurance commissioners.

At first glance, it may appear that every conceivably useful item of information is in the convention form of annual report. Efforts at analysis, however, will soon dispel this impression. In many respects the convention form and its schedules have become so complicated as to prevent the ordinary person from learning the basic facts about the business necessary to enable him to judge the success of the management of his company in handling the investment of his funds. Furthermore, there are many items of pertinent information which will not be found in any convention reports. The policy holder's problem is further complicated by the fact that reports are not prepared on the same basis by all the companies. This is especially true regarding the capitalization of real estate costs and expenditures. A few companies carry real estate at current appraised values; others use valuations the basis of which is not disclosed and which appear to have little relationship to present values. Appraisals showed for properties securing mortgages are sometimes recent and sometimes ten or more years old. There is nothing in the usual convention report, however, by which the policy holder without special knowledge of specific properties can determine the dates at which such appraisals were made. Some companies provide ratings for the bonds in their portfolios. Others do not.

In spite of the difficulties involved, however, the policy holder with sufficient tenacity of purpose will be able to form certain useful impressions about life insurance investments.

The safe investment of money is a fundamental concept of legal reserve life insurance, and recognizing this fact, life insurance executives have frequently characterized the assets of their companies as trust funds. This basic concept has been used as a selling argument of leading companies for many years and has doubtless been an important factor in the remarkable growth of the business. Policy holders have been encouraged to look upon their insurance companies not only as a means of providing protection to their beneficiaries, but also as a medium for the safekeeping of their savings. In recent years especially, premiums frequently have been paid years in advance, dividends in increasing amounts have been left with companies to accumulate, and more importance has been given to annuities and other forms of insurance which emphasize investment in contrast to pure protection.

This increasing development of what may be referred to as the banking aspect of the business has largely contributed to the fact that since 1931 assets have increased almost \$7,500,000,000 while insurance in force has increased only about \$1,000,000,000.

For perspective on life insurance investments, it will be well for the policy holder to note at the outset certain general tendencies of the business which can be best understood from an examination of aggregate figures relating to the business as a whole.

Life insurance companies operating in the United States on the legal reserve plan had total admitted assets of \$26,249,000,000 by the end of 1937, and it is estimated that the total had reached \$27,650,000,000 at the end of 1938.

During the period since December 31, 1929, life insurance assets have increased over \$10,000,000,000, or an average of over \$1,000,000,000 per year. That the companies have grown rapidly and steadily accumulated these vast aggregates of capital is evidence in itself that policy holders have accepted insurance and expressed their belief in the stability of their companies.

With this in mind, the policy holder may conveniently begin his consideration with the matter of investment income.

One of the principal functions of life insurance investments, of course, is to produce an adequate rate of return. The rate of return received from investments is of fundamental importance to the rank and file of investors, but is especially significant for life insurance companies in view of the fact that all life insurance contracts are based upon a rate of compound interest fixed in each policy. This assumed or contract rate, which is usually 3-1/2 or 3%, must be earned each year in order to maintain reserves. The policy holder, therefore, is vitally concerned with the extent to which this assumed or contract rate is covered by investment income. Let us see what the trend has been. According to *Spectator Year Book*, the margin of investment income of all companies over interest necessary to maintain reserves has been as follows:

1923	64.64%
1926	61.64%
1929	59.68%
1932	44.47%
1933	33.19%
1934	22.60%
1935	15.84%
1936	13.60%
1937	18.26%

Figures for 1938 for the business as a whole are not yet available, but an examination of the annual statements of five large companies whose margin was 17.3% in 1937 show a reduction to 13.4% in 1938. This is lower than any margin reported at any time for the last 30 years.

This narrow margin must also be considered in conjunction with the investment losses reported in the statements of insurance companies in recent years. In only one of the five years ended December 31, 1937 was there an excess of investment gains over losses as reported. This was in 1936. In each other year, losses were incurred, and in 1933 and 1937 these losses even exceeded the entire interest margin. Indications are that losses were generally reported again in 1938.

These reported gain or loss figures are in large part a reflection on the basis employed by the respective companies in the valuation of their assets rather than an indication of total gains or losses realized through actual sales. From this, the policy holder will recognize that figures reported as gain or loss are to a considerable extent within the discretion of management and that the condition of the company or companies with which they are primarily concerned may be made to appear considerably better than it really is by the failure of the management to frankly account for losses already indicated.

It is a matter of real importance, therefore, for the policy holder to be able to formulate an opinion on the extent to which his company overstates or understates its assets. Unfortunately, the tendency in many companies seems to be toward overstatement.

Not only is the life insurance business confronted with a declining margin of investment income within which to maintain reserves while the exact amount of its gains and losses from investment are left open to some conjecture by the valuation methods used, but many companies are also faced with relatively declining surplus. In fact, one of the matters which will immediately attract the policy holder's attention is the low level of surplus of many companies and its relative decline since 1929.

Certain leading companies, at the end of 1938, reported surplus of from 2.1% to 6.5% of total assets. The cases studied are in little danger of impinging upon the maximum prescribed by law.

The question as to whether or not this surplus is adequate for the full protection of policy holders, especially in time of economic stress, is a very important one, depending to a large extent upon the valuations placed upon the assets of the companies. Although it is a matter which

will require somewhat intensive study before a policy holder will be able to form definite conclusions, such a relative decline in surplus is nevertheless sufficiently important to stimulate as careful a study as available information will permit.

In order to understand this problem of surplus, it is important to consider the types of assets owned by insurance companies as well as the methods of valuation generally applied with respect to each type.

At the end of 1938, life insurance assets were 28.7% composed of cash and obligations of governmental units, 10.9% rail bonds, 15.3% public utilities and industrials, 19.4% mortgages, and 7.8% real estate.

The policy holder will find he must consider the valuation of three principal groups of assets, namely bonds, real estate mortgages, and real estate.

With respect to bonds, the rule followed by the companies is that bonds "adequately secured" and not in default may be carried at "amortized" values.

It is obvious that over a long period of time, cost and therefore amortized value (which is simply an adjusted cost value) bears no necessary relationship to market. In the case of high grade bonds, of course, their market price or value in exchange varies less from year to year than that of lower grade bonds, so that in the case of high grade bonds, amortized cost may be said to be a reasonably justifiable method of determining the value to be set forth in the annual statement. As the rule of carrying bonds at amortized values is applied to bonds relatively less secure, a more serious situation develops. This practice of valuation becomes progressively more questionable as the degree of security declines.

The provision that bonds adequately secured may be carried at amortized values seems satisfactory enough on its face. The difficulty comes in determining what bonds shall be classified as adequately secured and what bonds shall not. As this determination has been left to a substantial degree to the management of each individual company to determine for itself, some differences of opinion have developed.

Examples of such variations in practice are found in the case of Baltimore and Ohio 5s of 1950, and Missouri, Kansas and Texas 4-1/2s of 1978. Of six large companies, three owned B & O 5s of 1950 on December 31, 1938. Two carried these bonds at 99 or higher, the other at 34. The case of the MKT 4-1/2s of 1973 is similar. These bonds were owned by five of the six companies. Four carried them at 99 or above; the other at 32.

This wide difference of opinion on the part of the managements of some of the country's leading companies naturally raises the question as to whether or not all bonds stated to be adequately secured by the managements are in fact so secure by conservative standards that there is sufficient justification for including them in the list carried at amortized values.

The State of New York has promulgated a ruling intended to serve as a guide to companies domiciled in that state by stating the bonds rated in fifth grade or higher by any one or more of four principal bond rating agencies may be carried at amortized value, while bonds rated sixth grade or less must be carried at market.

In order to understand how this works out in practice, a study has been made which shows the difference between market values and amortized values of insurance company holdings of railroad bonds of six leading companies expressed as a percentage of market value of bonds of various ratings.

This study shows that of rails rated first grade, or AAA, at the end of 1938 these companies had a paper profit over amortized value of from 3.3% to 10.8%. In the second grade rail bonds, that is, the AA bonds, five companies had paper profits of from 2.6% to 6.6%, while one had a loss of 2.3%. In the third grade bonds, that is, the A's, all companies had losses except one which had a profit of .4 of 1%. In the fourth grade rails (those rated Baa) all six companies had a loss, which varied from 13.6% to 38.7%. This indicated loss amounted to over \$100,000,000 in the fourth grade rail bonds held by these six companies alone. The fifth grade bonds (that is, those rated Ba) showed such losses of from 45.1% to 70.3% in the six companies.

The indicated loss in the fifth grade rail bonds in the case of these companies was about \$114,000,000 or, in other words, these bonds were carried in the annual statements at an average of 58% above their market value.

The tendencies involved in this situation may be illustrated by specific examples of valuations of railroad bonds found in the portfolios of these six companies as of December 31, 1938.

In view of the relatively low yield obtainable from railroad bonds and other obligations of sound investment character, can anyone seriously contend that at the present time there is any justification for carrying bonds on an amortized basis which can be obtained in the open market at prices which would provide returns of from 10 to 60% if the bonds were paid off at face value and accrued interest at maturity? A list of such bonds showing the price at which they appear in the annual statements, compared with the market and the yield to maturity, based on market prices, is as follows:

	Annual Statement (Amortized Value)	Market	Yield to Maturity
Ann Arbor Railroad Co. 4s 1925	76	33	13.5%
Baltimore & Ohio 5s 1950	99	34	20.7%
Boston & Maine 4-3/4s 1961	97	28	20.0%
Colorado & Southern 4-1/2s 1980	95	43	11.5%
Georgia, Southern & Florida Ry. 5s 1945	100	43	20.5%
Hudson & Manhattan 5s 1957	90	45	14.0%
Illinois Central 3s 1951	82	46	11.0%
Jamestown, Franklyn & Clearfield 4s 1959	95	52	19.3%
Lehigh Valley 4-1/2s 1940	100	49	60.1%

It will be stated at once by supporters of the present system of valuation that, on the whole, market values of bonds owned at December 31,

1938 exceeded the aggregate admitted asset value which formed the basis for the companies' annual statements to policy holders. In the cases of four of the six companies examined by this policy holder, it is true that aggregate market values at the end of 1938 exceeded aggregate amortized values. In the other two cases there was a slight deficiency of market value as compared with amortized values. This is at the end of 1938 when the high-grade bond market is practically at an all time high.

There is no need to discuss the effects of a severe depression on bond prices. The experience of the last eight years is too vivid in our minds. It may be appropriate to reflect, however, what an era of prosperity might do to the market values of bonds with low coupons.

A simple calculation shows what happens to the price of a good 3-1/2% bond, such as the companies have bought in such large quantities in recent years, if long term money goes to a 4-1/2% yield basis.

Term to Run	Price of 3-1/2% Bonds corresponding to yield of 4-1/2%
15 years	89.2
20 years	86.9
25 years	85.1
30 years	83.6

This simple calculation indicates clearly that whether general economic conditions get better or worse, it is not unlikely that the life insurance business will again face a period when bond valuation may again become a very troublesome problem.

Perhaps the point can be clarified in another way. When a bond is carried at amortized value, there is involved the implicit assumption that it will be paid off at face value and accrued interest on its maturity date. This assumption is reasonably justified in the case of the highest grade bonds, but in the case of bonds selling in the forties, fifties, and sixties, for instance, the very market price is a public recognition that there is grave doubt that the bonds can be paid by the issuing corporation at their face value and accrued interest at maturity. It must be recognized that when bonds sell at a high premium, the operation of mathematical time factors always dissipates the premium, but when bonds sell at large discounts, this is a plain signal that loss is probable.

The method used in the valuation of real estate mortgages is much simpler and appears to be even less conservative. For the most part mortgages are simply carried on the books at the unpaid principal amount. This procedure, like the one applied in the valuation of bonds, seems reasonable enough on the assumption that all mortgages owned are sound and well secured. However, as there are in the cases of some companies, substantial amounts of mortgages with interest or taxes in default, it seems reasonable that some modification of this general practice might well be adopted for mortgages the security for which is known to be inadequate, or with respect to which there have been actual defaults in interest or taxes.

One of the most conspicuous illustrations noted in five large companies studied in this connection was a mortgage for \$300,000 made in 1922. By the end of 1938 the company's report showed over \$245,000 of interest in arrears and over \$246,000 of delinquent taxes. A somewhat similar case is that of a mortgage for \$2,400,000 with respect to which interest was past due to the extent of over \$322,000 and over \$140,000 taxes were in arrears. These mortgages were not in foreclosure.

Another case is that of a mortgage of \$650,000 face amount, bearing interest at one per cent, and with over \$58,000 of interest in arrears, in spite of the nominal rate. The appraised value of the land and buildings securing this loan was shown at \$375,000 (a reduction of \$1,240,000 from an earlier valuation), but nevertheless the loan was still carried in the assets of the company at \$650,000. These mortgages, of course, are especially flagrant cases.

No experienced observer will be surprised at finding such mortgages in large portfolios, for such are the fortunes of lending money, but to find them included in the companies' assets at their full face value is almost unbelievable. The aggregate amount of mortgages in default as to interest or taxes which were held at the end of 1938 amounted to from 6 to 24% of the entire mortgage account in the cases of these companies. This is an important matter because of the fact that mortgages held by these five companies aggregated over \$2,500,000,000 at the end of 1938. Many of these mortgages evidently are seriously delinquent. On the average, the delinquency was found to exceed 20 months' interest and cases are numerous in which delinquent interest amounts to from 15 to 30% of the entire principal sum.

The dangers of this practice of mortgage valuation apply with special force at the present time by reason of the fact that moratorium laws in force in many states have deprived companies of the ability to enforce amortization payments for a substantial period of years, so that to an important extent normal protection against depreciation of the underlying security has been removed.

The remaining asset the valuation of which a policy holder may well concern himself is foreclosed real estate. There appears to be no general rule among the companies about this.

Some carry real estate acquired in satisfaction of debt at the unpaid principal amount of the mortgage at date of foreclosure. Others in valuing their assets add to the unpaid principal amount of the defaulted mortgages foreclosure expense, taxes, rehabilitation costs and even unpaid interest from the date of default to the date of receipt of title, or some part of that period. Some companies have written down certain real estate deemed by the management to be over-valued; others have not. The real estate owned by five large companies on December 31, 1938 may be taken as an example. These companies held real estate acquired through foreclosure in the amount of over \$890,000,000 at that time. About \$270,000,000 of this was city real estate and \$220,000,000 was farms. About \$80,000,000 or 9% of it was under contract of sale, and over \$750,000,000 or 84% of it was not under contract of sale and had been held more than one full year.

A substantial proportion of these properties are not showing any earnings after deducting cash operating expenses and taxes and many have been reporting sizeable operating losses for the past three years.

Obviously, it is extremely difficult to obtain an accurate idea of the valuation of real estate without individual inspection of properties. This few policy holders have the time or the experience to do.

There are, however, some general criteria which may be applied. I refer to the use of so-called economic valuations, that is, capitalization of earning power. This method of valuation is of limited usefulness in connection with farms, and is open to some objections in the case of residences, but has a certain validity in the case of city income property. The data in annual statements to the insurance departments do not permit of accurate analysis, but a rough approach to the problem of valuation may be made by eliminating properties carried at less than \$25,000. The valuations of the city properties carried at \$25,000 per property and over, which had been owned one full year or more, and were not under contract of sale, show extremely wide variation in relation to their 1938 gross income in different companies. One of the five very large companies carried such real estate at 14.35 times gross income, another at 9.20 times gross, another at 7.25 times and the remaining two at 6 and 5.50 times gross respectively.

Such variations are of themselves grounds for serious misgivings about real estate valuations, but in order to further verify his impressions of over-valuation, a policy holder may with benefit analyze the relationship of actual sales prices to gross income of property disposed of by these companies in 1938. Analysis of a substantial sample of such sales shows real estate actually sold in 1938 was disposed of at prices of about 5½ times gross income on the average. On this basis, at least \$100,000,000 of pure optimism is indicated in the real estate valuations of these five companies.

The foregoing facts present a picture of overvaluation in insurance company assets which should certainly be rectified. Investments in Eaa and Ea rails appear in the annual reports of six major companies at figures which are \$214,000,000 higher than the market value of the securities. A total of \$2,500,000,000 of mortgages are listed in the annual reports of five leading companies at figures which fail to reflect the fact that from 6% to 24% of the mortgages are delinquent. Holdings of almost \$900,000,000 of foreclosed real estate are listed in the annual reports of the same five companies at valuations which, on the average, range as high as 14 times gross earnings despite the fact that the current market will support a rate of no more than 5½ times gross earnings.

It is time to stop playing Blind Man's Buff with value. This policy holder believes that companies should take immediate steps to reduce unrealistic valuations which appear to exist, so that they may put themselves in the best possible position to face the adjustments which will become necessary either in the event of a higher level of interest rates or in the event of the occurrence of another prolonged depression.

In the comparatively brief period between 1930 and 1938, 40 life insurance companies, many of which had been in business over a long period of time, have failed.

During the period from 1931 to 1935, it was perhaps necessary and justifiable in recognition of economic conditions and the maintenance of public confidence to place convenient and convention values upon the assets of the insurance companies.

Surely the time has now arrived, however, for the managements of all our life insurance companies to take immediate steps to place sound and conservative valuations upon all their assets.

It is sometimes stated that insurance companies do not have to write assets down because they are so strong. A sounder point of view, however, is that they must write them down while they are strong if the confidence reposing in them by their policy holders is to be justified.

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